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ACCOUNTING

Principles and Procedure

UNDER THE EDITORSHIP OF

EDGAR S. FURNISS

DEAN OF THE GRADUATE SCHOOL

YALE UNIVERSITY

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ACCOUNTING

Principles and Procedure

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PREFACE

THIS book undertakes to provide, for a first-year college course in Accounting, a text that is accurate and logical and at the same time simple, teachable, and interesting. It is the result of many years of practical experience both in the classroom and in business. The authors know that the material in it is usable in the classroom and also directly applicable to actual business procedure.

The text is divided into two parts, with a separate laboratory manual to accompany each part. Part One covers the work of the first semester and Part Two that of the second.

In Part One, the theory of debit and credit is clearly explained, illustrated, and applied to short practical exercises; this theory, as the basic principle of all accounting, must be clearly understood by the beginner. The student is taken through the complete cycle of accounting operations, using a simple service business as a basis. Complications, due to mixed accounts and adjustments, are avoided until the beginner has become thoroughly familiar with the basic procedures of ordinary bookkeeping. The first seven chapters complete this cycle of accounting operations, which consists of journalizing, posting, trial balances, financial statements, and closing the books.

These operations are all reviewed in the following eight chapters in a more involved manner, using a trading business to illustrate the expansion of the nominal accounts. Labor-saving devices, such as special journals and controlling accounts, are next introduced. Business forms, negotiable instruments, and banking procedure are special topics also considered in these chapters.

Part Two provides a variety of interesting problems and procedures. The first five chapters in this section are de-

voted to adjusting entries and the preparation of financial statements. Two methods of analysis are presented: the familiar working-sheet method and the analysis-sheet method. Through the use of these methods the student is given an intensive drill in the preparation, analysis, and technique of financial statements. The further development of special journals is illustrated through a practice set, which introduces departmentizing of a business and expense classification and analysis.

The remainder of Part Two is devoted to ownership and management problems relating to different types of business organization. Partnership problems are presented in some detail, but the principles of corporation accounting are given in general only, as this important and difficult field is usually covered in an advanced course. A chapter is devoted to the explanation and discussion of single entry bookkeeping and the preparation of statements from such a system.

A special feature is the laboratory manual plan, a separate manual being provided for each semester's work.

The authors present this text as a simple logical development of the principles of accounting, presented in a manner comprehensible to the student.

No matter how well this work may have been planned and developed, it can, of course, never take the place of the living teacher. It is hoped, however, that it may be a genuine help to student and teacher alike.

Grateful acknowledgment of appreciation is due to many sources too numerous to mention here. Especial thanks are due to the other members of the accounting department staff for their many helpful suggestions and to Miss Nina A. Richardson, secretary of the department, for assistance in preparing the manuscript.

W. J. G.
J. V. T.

CONTENTS

INTRODUCTION	1
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PART I

I. PROPERTY AND INTERESTS IN PROPERTY . . .	11
II. BUSINESS TRANSACTIONS AND THEIR EFFECT ON BALANCE SHEET EQUATION	22
III. ACCOUNTS: THEORY OF DEBIT AND CREDIT . . .	32
IV. APPLICATION OF THE THEORY OF DEBIT AND CREDIT. DOUBLE ENTRY BOOKKEEPING	49
V. TRIAL BALANCE	68
VI. INTERPRETATION OF THE RECORDS	81
VII. CLOSING THE BOOKS	91
VIII. ACCOUNTING FOR A TRADING BUSINESS . . .	101
IX. MODEL ILLUSTRATIVE EXERCISE — TRADING BUSI- NESS	118
X. NEGOTIABLE INSTRUMENTS	141
XI. SUBDIVISION OF THE JOURNAL	158
XII. BANKING RELATIONS, INTEREST, AND DISCOUNT .	174
XIII. CONTROLLING ACCOUNTS: FURTHER DEVELOPMENT OF SPECIAL JOURNALS	200
XIV. OTHER SPECIAL JOURNALS	224
XV. SUMMARY OF PRECEDING CHAPTERS	233

PART II

XVI. ADJUSTMENTS — INVENTORIES	247
XVII. ADJUSTMENTS — DEPRECIATION — RESERVE AC- COUNTS	262

XVIII. WORKING SHEETS AND ANALYSIS SHEETS . . .	280
XIX. THE BALANCE SHEET	308
XX. THE PROFIT AND LOSS STATEMENT — REVERSING ENTRIES	321
XXI. DEPARTMENTALIZATION	337
XXII. EXPENSE CLASSIFICATION AND DISTRIBUTION . .	352
XXIII. PARTNERSHIPS	363
XXIV. PARTNERSHIP ACCOUNTS	373
XXV. ADMISSION OF A PARTNER	397
XXVI. ADMISSION OF A PARTNER (<i>continued</i>) . . .	408
XXVII. PARTNERSHIP DISSOLUTION	422
XXVIII. TYPES OF BUSINESS ORGANIZATION . . .	434
XXIX. SINGLE ENTRY BOOKKEEPING PROCEDURE . .	452
INDEX	469

ACCOUNTING

Principles and Procedure



INTRODUCTION

Accounting. Accounting is a science the principles of which are used: (a) to record, in terms of money, property values; the interests in property; and the transactions involving property and the interests in property; (b) to analyze the records of values for the determination and the interpretation of the effects of transactions on the property and the interests therein.

History of Accounting. While there has always been some form of accounting, however crude, since property came into being, the history of our modern accounting really begins with the work of Lucas Pacioli, an Italian, who published the first printed treatise on the subject in 1494. His book entitled *Summa de Arithmetica, Geometria, Proportioni, et Proportionalita* (Everything about Arithmetic, Geometry, and Proportion) was intended to summarize the existing knowledge of mathematics. Later the scope of this work was extended to give "Complete instruction in the ordering of business." This part of the work was entitled *de Computus et Scripturis* (concerning accounting and recording) and contained thirty-seven short chapters.

Pacioli in this part of his work addressed the subjects of the Duke of Urbin as follows: "I have prepared another particular treatise, very necessary to compile, in addition

to the things already dealt with in this work. The present treatise will serve all their needs with regard to accounts and recording. . . . I, therefore, intend to give sufficient rules to enable them to keep all their accounts and books in an orderly manner." The system outlined by Pacioli is fundamentally our double entry system of to-day.

Since the work of Pacioli was written, there have been many writings from time to time in the various countries of Europe, in England, and recently in the United States. Those countries which developed most rapidly in commerce, trade, and industry naturally have led the way and furnished many accountants, some of whom have written with authority on the subject of Accounting. During the present century more literature has been produced on Accounting than ever before and particularly during the period from 1910 to the present time. This has been largely due to the rapid growth of large business units and the requirements of the various laws regulating and taxing business.

The need for accurate and scientific accounting in the administration of modern business has been keenly recognized by executives in business. Much study has been given the science by trained minds, and a great amount of literature has been published dealing with all phases of the subject and the application of the theories to all types of businesses and social and economic institutions.

Legal Recognition in the United States. The earliest legal recognition of accounting in the United States was a statute enacted by the Massachusetts Legislature in 1826. By this act it was ordained that every town of five hundred families should provide a master to give instruction in several subjects of secondary-school grade. The first subjects mentioned were History of the United States and Book-

keeping. In 1896, the State of New York passed the first law requiring the registration of accountants, and granting the right to the title Certified Public Accountant. Since that date, practically all States and Territories have enacted similar laws.

Development of Commercial Subjects in Schools and Colleges. Bookkeeping has been taught in the United States since 1826. For a long time the major part of the teaching of such commercial subjects as Bookkeeping, Shorthand, and Typewriting was carried on by private business schools. These schools have been and are still very prominent in commercial educational circles in the United States.

During the past half-century we have seen these commercial subjects develop rapidly in our public secondary-school system. One after another public high schools organized and established commercial departments and in the larger cities separate high schools of commerce were established, so that at the present time there is hardly a high school in the country without a commercial department. During the last thirty years this development of commercial work in secondary schools has been followed by the introduction of commercial studies in our colleges. Separate departments and colleges of business administration have been established in nearly all the colleges and universities in this country, Canada, Cuba, and Porto Rico. This very great expansion of commercial education is a direct result of the growth of business units and of the commerce and industry of the United States.

The first school of commerce of collegiate grade to be established was at the University of Pennsylvania, where the Wharton School of Commerce and Finance was founded

in 1881. The next college to found a separate department was New York University, in 1901. Since that date others have followed, the great majority being started during the past twenty years.

In 1908, the Graduate School of Business was founded at Harvard University and it marked the establishment of graduate schools of business in our colleges.

Professional Societies of Accountants. Professional societies of accountants have played an important part in fostering and encouraging the growth and development of accounting. Professional accountants were in existence long before the national organizations were formed. The accounting profession in the United States has followed the development of the profession in England and Scotland. Many of our first professional accountants were English and Scottish accountants who came to this country and set up an office to practice accounting.

It is interesting to note a few approximate dates of the founding of professional accounting societies of Scotland, England, and the United States. In 1853, in Edinburgh, Scotland, the Institute of Accountants was founded. In 1880, the Institute of Chartered Accountants was incorporated in England, marking the beginning of modern accounting there. In 1885, the Society of Incorporated Accountants and Auditors was formed. These two societies in England were the forerunners of the American Association of Public Accountants, which was established in 1887 in New York. This association was succeeded and absorbed in 1916 by the American Institute of Accountants. The American Society of Certified Public Accountants was formed in 1921. The National Association of Cost Accountants, an organization composed of accountants and

business executives interested in cost accounting, was founded in 1919. These societies, composed of accountants and those interested in accounting, foster and encourage the advancement of the profession of accounting.

In the past twenty years, due to the necessity for accurate and scientific accounting in the administration of modern business and the requirements of the various income tax laws, great progress has been made in this science. As the importance of accounting in business has become more keenly realized, more intensive study has been given the science by trained minds, and a great amount of literature has been published dealing with the theory of accounting and the application of this theory to all types of business.

Accounting and Bookkeeping. As previously defined, accounting is a science. As such it consists of a body of clearly defined principles. Logical reasoning is required in applying these principles to business operations. These principles are used as a basis for planning and making the record of property values and of transactions involving property values and the interests in property.

The actual making of the record, in accordance with the principles of accounting, is the art of bookkeeping. Bookkeeping is the actual physical writing of the records in the proper books, in the manner indicated by the principles of accounting.

There is, therefore, a clear distinction between accounting and bookkeeping. Accounting is the science, the principles of which are used *in the doing*; and bookkeeping is the *art of doing*. Bookkeeping, therefore, is a branch of accounting, in the same manner as arithmetic is a branch of the science of mathematics.

Accounting and Economics. Economics has been defined as a science of business. Accounting has also been described as a science of business. Both subjects deal with business, but from different points of view.

The *economic* units of analysis are society as a whole, groups in society, and the individual. Economists study production, distribution, and consumption of economic goods, prices, value, utility, labor, and capital as they affect the individual in society. The *accounting* units of analysis are the individual enterprise, the business transaction, the account, and the balance sheet. The accountant studies methods of carrying on business, vouchers and records, and the effect of transactions on the ownership of business enterprises. Economics and accounting are allied subjects. A knowledge of one is essential to a good understanding of the other.

Accounting and Law. The rights of parties to contracts, rights to property and civil rights, are defined by law. Accounting, dealing as it does with the analysis of values of ownership rights in property, in the analysis of the operations of the business, and in the problems of management and efficient handling of the affairs of the business enterprise, often comes into contact with the law.

The profession of law interprets and defends the legal rights of parties to contracts in case of dispute or misunderstanding. The profession of accounting records the transactions resulting from contracts in such a manner that the legal rights of the parties to the contract may be clearly exhibited.

Accounting and Management. Accounting should aid the management by revealing facts, conditions, and tendencies which may have been the cause of errors in the past,

and which may be profitably used by the management in the conduct of the business. Present-day accounting strives not only to obtain satisfactory records, but also to interpret them to serve as a basis for management, both general and financial; also to aid in developing plans and methods of efficient operation of business enterprises.

The importance of accounting as an aid to business management is well expressed in the following extract taken from an address made by the head of one of our largest business enterprises:

“As I see the picture, business — and I believe that this applies quite generally to large business as well as small business and both to the production and distribution end — lacks an appreciation of the possibilities of what can be accomplished through accounting. The more popular conception of this subject is to enable us to know how we stand at the end of any period. In other words, it is a matter of history.

“Too many lines of business have established accounting systems because they recognize it as the right thing to do. They have not, however, an adequate appreciation of what its tremendous possibilities are.

“While it is important to know our status at any time, it is still far more important to understand and appreciate the various factors and influences that underlie our whole structure to the end that we can look forward, by means of our accounting system, and can alter our procedure or policies to the end that a better operation results. In one case we are in principle, looking backward — in the other case, forward.”

PART I

CHAPTER I

PROPERTY AND INTERESTS IN PROPERTY

Property. The term *property* is used to denote everything, tangible or intangible, which has a value expressible in terms of money and which is subject to individual or collective ownership. Automobiles, real estate, merchandise, bonds, stocks, money, promises to pay money, patents, and franchises are examples of property.

Ownership of Property. Everything of value is owned either by some person or by a group of persons recognized by the law as the owner. This owner has the right to use, enjoy, sell, assign, rent, or to do anything he pleases with the property, subject only to the restrictions of the law. The owner may be an individual, two or more individuals in the form of a partnership, a group of individuals in the form of a trust, a corporation, or a State.

A party may acquire property rights by any one of the following methods:

1. Right of eminent domain (State)
2. Inheritance
3. Gift
4. Discovery or finding (according to statute law)
5. Exchange of other property; that is, by barter
6. Exchange for services
7. Purchase for cash
8. Purchase on an expressed or implied promise to pay for the property in the future

Property acquired by any of the first seven methods belongs to the owner free and clear of all claims of others;

the owner's interest in such property is the total value of the property owned. Thus, if a man named John Black owns \$15,000 in cash, land worth \$10,000, a house worth \$20,000, and investments worth \$10,000, his total interest in the property owned is the sum of the individual values, or \$55,000.

Assets. The properties owned by or amounts due to a person or business are called *assets*. Assets are of different types:

1. Properties owned or in possession, where title is in the holder. These properties may be tangible or intangible.

Examples of *tangible assets* are cash (all forms of money), merchandise (goods bought for resale), furniture, automobiles, equipment, land and building (real estate). Examples of *intangible assets* are goodwill, patent rights, copyrights, and secret formulæ.

2. Amounts due to a person or firm. These are called *intangible receivables*. They are claims against the property of another person or firm, arising out of sales not paid for (called *sales on account*), or for services performed for which payment in full has not been made.

These claims are called *accounts receivable* when they represent oral or implied promises to pay, and *notes receivable* when a written promise is given and received.

3. Rights in property of other businesses represented by transferable securities called *stocks and bonds*.

Capital. The value of the owner's interest in the properties owned, that is, in the assets of which he is the legal owner, is called *owner's capital* or simply *capital*.

This interest may also be called proprietary interest, proprietorship, net worth, present worth, or net assets. These terms all refer to the amount of the property which may be regarded as belonging exclusively to the owner after all

other interests in the property have been deducted from the total value of the property.

In a simple case, like that of John Black mentioned on page 12, where no others besides the owner have an interest in or claim against the property, the owner's capital or simply capital may be expressed in an equation like this:

ASSETS		=	CAPITAL	
Cash	\$15,000		John Black's interest	
Land	10,000		in the assets	\$55,000
House	20,000			
Investment	10,000			
Total	<u>\$55,000</u>		Total	<u>\$55,000</u>

This is purely a record of the assets owned and the interest of John Black in these assets. No consideration is given as to how John Black acquired this property.

Property Acquired on Credit. Usually property which is purchased on a promise to pay in the future becomes, at the time of purchase, the property of the buyer. For this property, the buyer gives to the seller a promise to pay for the property at a future time. Until this promise is fulfilled, the seller has a claim against not only the property sold on credit, but also against all the other assets of the purchaser. The buyer, therefore, in reality parts with an interest in all the property which he owns.

The person who *owes*, or who is indebted to another, is called a *debtor*.

The person to whom a value is *owed*, or to whom another is indebted, is called a *creditor*.

One person may be both a debtor and a creditor; that is, he may owe debts to certain people, and is therefore a debtor to them, they at the same time being his creditors. Other persons may owe him money and he is their creditor, while they are debtors to him.

Liabilities. The amounts owed by a debtor are called his *liabilities*; they are the claims of others against his property. Liabilities may be oral, written, or implied promises to pay. Oral or implied promises to pay are called, by the debtor, *accounts payable*. The written promises of the debtor to pay money in the future are called *notes payable*.

Precedence of Creditors' Interest (Liabilities). While the interest of creditors can be enforced only by legal procedure, yet in determining the proprietor's interest, these liabilities are first deducted from the assets. In other words, the creditor's interest has precedence over the proprietor's interest in his properties.

Illustration of Property Acquired on Credit. Assume that John Black, the relation of whose capital and assets have been shown by means of the equation ($\text{Assets} = \text{Capital}$), purchases an automobile for \$1,200, giving in exchange a written promise to pay for the automobile at the end of three months. This written promise is called by the debtor, John Black, a *note payable* and by the creditor a *note receivable*.

John Black becomes the legal owner of the automobile and his assets have increased by the value of this automobile. But he has given a written promise to pay for this automobile in three months, which amounts to giving the creditor an interest in, or claim against all of his assets, to the extent of \$1,200. In other words, if he fails to pay the \$1,200 in three months, the creditor may through legal proceedings levy on all or any one of his assets and obtain therefrom the amount due.

Creditors' and Proprietor's Interest in Property. There may be, therefore, at one and the same time, two interests in property, namely, the interest of the proprietor, known as his capital, and the interest of the creditors known as

liabilities. Obviously, the sum of these two interests must equal the value of the property. These interests may be expressed in the form of the following equation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

This equation in the case of John Black after he had purchased an automobile and given his note therefor may be expressed as follows:

(FORM I)

ASSETS		=	LIABILITIES + CAPITAL	
Cash	\$15,000		Notes Payable	\$1,200
Land	10,000		John Black's capital	55,000
House	20,000			
Stocks and Bonds	10,000			
Automobile	1,200			
Total	<u>\$56,200</u>		Total	<u>\$56,200</u>

Inasmuch as the interests of creditors have precedence over the capital, this same equation may be expressed in the following form:

$$\text{Assets} - \text{Liabilities} = \text{Capital}$$

This equation expressed in statement form appears as follows:

(FORM II)

ASSETS	
Cash	\$15,000
Land	10,000
House	20,000
Investments	10,000
Automobile	1,200
Total assets	<u>\$56,200</u>
LIABILITIES	
Notes Payable	<u>\$1,200</u>
CAPITAL	
John Black's capital	\$55,000

Balance Sheet. A technical statement of this kind showing the property owned, and the creditors' and proprietor's interests therein, is called a *balance sheet*.

Balance Sheet Equations. Inasmuch as the balance sheet is always based upon one of the two equations given up to this point, these equations are called *balance sheet equations*.

Fundamental Distinction Between Creditors' and Proprietor's Interests. The owner of property has the sole right to the increases in the property resulting from its investment or productive use. He must also bear the decreases (losses) in the property resulting from its investment or use. The creditor, on the other hand, does not participate in such increases or decreases. His interests remain the same until he is paid. In other words, the liabilities remain constant regardless of any increases or decreases in the property of the proprietor.

Insolvency. When, due to decreases in the assets, the liabilities (i.e., the creditors' interest in the property) exceed the value of the property owned, the excess is called *net insolvency*.

The proprietor's interest or capital then becomes a deficiency of capital.

For example, S. S. Sloan owns in cash \$150, land, \$3,000, buildings, \$8,000, making a total of \$11,150. He owes at the same date debts to John Adams, \$4,000, to the Union Bank, \$6,000, and to William A. Mason, \$3,200, making a total of \$13,200.

The total of his liabilities, \$13,200, exceeds the total of his assets, \$11,150, by \$2,050. This amount, \$2,050, is

called the *net insolvency*. The balance sheet equation, then, assumes this form:

$$\begin{array}{rclclcl} \text{TOTAL ASSETS} & + & \text{NET INSOLVENCY} & = & \text{TOTAL LIABILITIES} \\ \$11,150 & + & \$2,050 & = & \$13,200 \end{array}$$

It is evident in this case that the creditors' interest is impaired and that the creditors cannot receive 100 per cent of their claims.

The Business Enterprise. The primary purpose of all business enterprises is, through the rendering of some service, to increase the value of the capital or, in common parlance, "to make money."

The proprietor or owner of a business usually takes a certain amount of the money or property which he has accumulated, and places it aside for the use of his business. Such money or property is called the *proprietor's investment* or capital. He expects, through the use of this investment in the operation of the business, to increase the value of his interest in the properties owned by the business.

Business Property Separate in Accounting from Private Property. The money, or property, invested by the proprietor in a business remains his property, but for the sake of accounting, such property is treated as *separate* property and recorded as such on the business books.

Assume that John Black, who previously has been working for a salary, decides to establish a business of his own, selling electrical refrigerators for a group of manufacturers on a commission basis. He merely secures the orders and forwards them to the manufacturers to be filled directly by them. He is to receive a commission at a rate fixed by the manufacturers on all orders accepted by them, payable upon the shipment of the goods.

John Black would investigate the financial requirements of such a business to determine the amount of capital required. Inasmuch as he does not buy any of the goods himself, but is to act merely as selling agent, he will not have to provide money for goods nor finance sales on credit. He decides that \$6,000 will be an ample amount with which to carry on this business. After taking from his personal assets (see page 15) the \$6,000 which he decides to invest in the business, his proprietary interest would be shown as follows:

1. *Proprietary Interest in Private Property:*

ASSETS		=	LIABILITIES + CAPITAL (Private)	
Cash	\$ 9,000		Notes Payable	\$ 1,200
Land	10,000		Capital	49,000
House	20,000			
Stocks and Bonds	10,000			
Automobile	1,200			
	<u>\$50,200</u>			<u>\$50,200</u>

2. *Proprietary Interest in Business Property:*

ASSETS		=	LIABILITIES + CAPITAL (Business)	
Cash	\$6,000		000	+ \$6,000

His total personal capital is the sum of the capital interest in private property plus the capital interest in business property.

$$\$49,000 + \$6,000 = \$55,000$$

It is possible for John Black to be interested in several business enterprises at the same time, provided he can find competent assistants to help in the management of the separate enterprises.

The following form summarizes John Black's condition as of December 31, 19—.

JOHN BLACK
BALANCE SHEET, December 31, 19—.

ASSETS	PRIVATE	BUSINESS	TOTAL
Cash	\$9,000	\$6,000	\$15,000
Land	10,000		10,000
House	20,000		20,000
Stocks and Bonds	10,000		10,000
Automobile	1,200		1,200
Total	<u>\$50,200</u>	<u>\$6,000</u>	<u>\$56,200</u>
LIABILITIES AND CAPITAL			
Notes Payable	\$1,200	—	\$1,200
John Black's capital	49,000	6,000	55,000
Total	<u>\$50,200</u>	<u>\$6,000</u>	<u>\$56,200</u>

Desirability of Separate Accounting for Investments in Business. Too great emphasis cannot be placed on the advisability of keeping careful records of the transactions of the business and in rigid separation of business transactions from the private transactions of the proprietor. By so doing the results of the operation of the business may be accurately determined and the information necessary for the preparation of the various returns required by federal and state authorities may be readily obtained. One of the very common causes for the failure of business enterprise is the ignorance of the proprietor of his actual financial condition.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. In what respects does the science of accounting differ from:
 - (a) Economics?
 - (b) Law?
 - (c) Management?
 - (d) Bookkeeping?
2. An author begins his definition of accounting as follows: "Accounting is that branch of economics etc..."

Is accounting a branch of economics? If so, why? If not, why? Illustrate your answer.
3. What are the essentials of property from an accounting point of view?
4. John L. Dall owns the following: cash, \$3,000, land, \$1,200, debts due to him, \$1,600, and buildings, \$26,000.
 - (a) What are his total assets?
 - (b) What is his capital?
 - (c) Express his capital in the form of an equation.
5. H. A. Hall owns cash \$6,000, bonds and stocks worth \$40,000, land and buildings worth \$30,000, and an automobile worth \$3,000. He owes the United Trust Company on a promissory note \$12,000 and he owes William Steele \$6,000.
 - (a) What is the total value of the assets owned?
 - (b) What is the amount of the creditors' interest in the assets?
 - (c) What is the amount of H. A. Hall's capital?
 - (d) Express in the form of an equation the property owned by H. A. Hall and the various interests therein. Show two forms.
6. J. M. Dunn owns cash \$1,200, land and buildings worth \$12,000, debts due to him \$1,400. He owes A. L. Dore \$2,000, the First National Bank \$14,000, and A. K. Mason \$2,800.
 - (a) What is the value of the assets owned by J. M. Dunn?

- (b) What is the amount of the creditors' interest in the assets?
- (c) What is the amount of J. M. Dunn's capital?

Note: When the creditors' interest exceeds the value of the assets, the excess is called *net insolvency*.

- (d) Express in the form of an equation the property owned and the various interests therein.

- 7. What is an asset? Name several different assets.
- 8. Define liabilities; capital.
- 9. Why are liabilities subtracted from assets in order to obtain owner's capital?
- 10. What is meant by net insolvency?
- 11. What is a distinguishing characteristic of a business enterprise?
- 12. What is the difference between the business property and the private property from the point of view of use?
- 13. Why should the property used for the business be accounted for separately?
- 14. May an individual have business capital in more than one business enterprise?

CHAPTER II

BUSINESS TRANSACTIONS AND THEIR EFFECT ON BALANCE SHEET EQUATION

IN the previous chapter, it was shown that the sum of the assets owned is always equal to the sum of the interests, both creditors' and proprietor's, in those assets. This principle is expressed by the balance sheet equation:

$$\text{Assets} = \text{Liabilities} + \text{Capital}$$

It is obvious that if the value of the assets increases, one or both of the interests in the assets must also increase. If the value of the assets decreases, one or both of the interests in the assets must decrease.

Business Transactions. Any exchange of property or interests in property or service for other property or property interest or service is called a *business transaction*.

Business transactions may be very simple or very complex. Thus, a purchase of a morning newspaper is an exchange of property for other property, and is a simple transaction, whereas a purchase of a parcel of real estate, with the arrangement of a mortgage loan and various adjustments of taxes, insurance, and interest, is an exchange of property, property interests, and service and is a very complicated transaction.

Transactions occur in great variety and are very numerous in most business enterprises.

Changes in the balance sheet equation result principally from business transactions, which may be classified as follows:

1. *Transactions in which the total assets increase and the capital increases a like amount.* (Investment in business enterprise.)

Example: John Black invests \$6,000 in a commission business. This results in an increase of the business asset, cash, of \$6,000 and an increase of capital interest in the business of a like amount.

Before starting a business, the condition is zero; therefore, *whatever* is invested in the business results in an increase. This may be expressed in equation form as follows:

ASSETS	=	LIABILITIES	+	CAPITAL
Cash	\$6,000	0	+	John Black \$6,000

2. *Transactions in which the total assets remain the same, with no increase or decrease of liabilities or capital.* (Exchange of assets.)

Example: John Black buys office furniture valued at \$500 and pays cash for the same. In this transaction, John Black receives office furniture costing \$500 and gives in exchange another asset, cash to the value of \$500. He has merely exchanged one type of property for another without in any way affecting either the liabilities or the capital.

The summary of John Black's business condition might now be shown as follows:

ASSETS	=	LIABILITIES	+	CAPITAL
Cash	\$5,500	000	+	<u>\$6,000</u>
Office furniture	500			
	<u>\$6,000</u>			

3. *Transactions in which the assets increase with a corresponding increase in liabilities.* (Purchase of assets on credit.) In this kind of transaction there is no change in capital interest.

Example: John Black buys a typewriter and an adding machine for \$320 on account, that is, agreeing to pay for them in the future, thus giving the Union Office Appliance Company an interest in all his assets up to the amount of \$320. He has increased his assets by \$320 and has increased his liabilities by the same amount. This may be expressed in equation form as follows:

ASSETS		=	LIABILITIES	+	CAPITAL
Cash	\$5,500		Union Office		John Black \$6,000
Office furniture	500		Appliance Co.,	\$320	
Office appliances	320				
Total	<u>\$6,320</u>			<u>\$320</u>	+ <u>\$6,000</u>

4. *Transactions which affect the liabilities only.* (Exchange of liabilities.) One liability is exchanged for another without change in assets or capital.

Example: John Black gives the Union Office Appliance Company a written promise to pay in thirty days (called a *note payable*) for the goods purchased for \$320 in transaction 3. This is merely a substitution of a written promise to pay for an oral or implied promise, and does not affect either the assets or the capital. There is no change in the equation; merely the form of the liabilities have been changed.

ASSETS		=	LIABILITIES	+	CAPITAL
Cash	\$5,500		Notes Payable	\$320	John Black \$6,000
Office furniture	500				
Office appliances	320				
Total	<u>\$6,320</u>			<u>\$320</u>	+ <u>\$6,000</u>

5. *Transactions in which the assets decrease with a corresponding decrease in the liabilities but in which no change occurs in capital.* (Payment of a liability.)

Example: John Black pays the Union Appliance Company cash in payment of note for \$320 which is due to-day. In this transaction the asset, cash, is reduced \$320 and the liabilities a like amount. The equation will now show the following:

ASSETS		=	LIABILITIES	+	CAPITAL
Cash	\$5,180		0		John Black \$6,000
Office furniture	500				
Office appliances	320				
Total	<u>\$6,000</u>		<u>000</u>	+	<u>\$6,000</u>

6. *Transactions in which the assets decrease with a corresponding decrease in capital interest, but which do not affect the liabilities.* (Payment for services.)

Example: John Black pays \$100 cash for salaries of employees for the past week. In this transaction, John Black has received the services of

his employees for the week but for these services nothing permanent remains nor has he any tangible exchangeable property. He has reduced his asset, cash, \$100, and his capital interest is reduced a like value. The equation will then be as follows:

ASSETS	=	LIABILITIES	+	CAPITAL
Cash	\$5,080	0	John Black	\$5,900
Office furniture	500			
Office appliances	320			
Total	<u>\$5,900</u>	<u>000</u>	+	<u>\$5,900</u>

Expense. An expenditure, that is, a payment of cash or the engaging to pay cash for a value received, which value is not tangible or exchangeable and which has the effect of reducing capital is called an *expense*.

7. *Transactions in which the assets increase with a corresponding increase in capital, but which do not affect the liabilities.* (Receipt of cash for services.)

Example: John Black receives a check for \$300 from the Home Manufacturing Company in payment of commission earned by him on goods sold to A. L. Doane. In this transaction, John Black receives cash \$300, increasing his assets by this amount. No asset is parted with, nor is any liability incurred. His capital, therefore, is increased by \$300.

This equation shows the following:

ASSETS	=	LIABILITIES	+	CAPITAL
Cash	\$5,380	0	John Black	\$6,200
Office furniture	500			
Office appliances	320			
Total	<u>\$6,200</u>	<u>000</u>	+	<u>\$6,200</u>

Income. An increase of assets which results in an increase of capital interest is called *income*.

8. *Transactions in which capital is decreased and the liabilities increased, but in which no change occurs in assets.* (Purchase of services on credit.)

Example: John Black has inserted in the *Evening Times* an advertisement costing \$60 to be paid on the 10th of the following month.

In this transaction, John Black has incurred a liability to the Evening

Times Company, thus increasing his liabilities by \$60 and inasmuch as the advertising has no tangible or exchangeable value, his capital interest is decreased a like amount. The balance sheet equation will now appear as follows:

ASSETS	=	LIABILITIES	+	CAPITAL	
Cash	\$5,380	Evening Times Co.	\$60	John Black	\$6,140
Office furniture	500				
Office appliances	320				
Total	<u>\$6,200</u>		<u>\$60</u>	+	<u>\$6,140</u>

Note: Observe that this transaction has decreased the capital due to the incurring of a liability for an expense.

9. *Transactions in which liabilities are decreased and the capital is increased, but in which no change occurs in assets. (Reduction of a liability.)*

Note: While transactions of this class are not numerous, they do occur during panics and business depressions, when creditors waive some of their interest in the assets to enable the owner of the business to avoid bankruptcy, or when adjustments are allowed by a creditor due to his failure to carry out the contract as agreed.

Example: While John Black is ready to pay for his advertising, he claims the advertisement was poorly printed and the Evening Times Company cancels one half the charge, making their interest in John Black's property \$30.

In this transaction, the liabilities are decreased by \$30 and John Black's capital is increased a like amount. The balance sheet equation now appears as follows:

ASSETS		=	LIABILITIES		+	CAPITAL	
Cash	\$5,380		Evening Times Co.	\$30		John Black	\$6,170
Office furniture	500						
Office appliances	320						
Total	<u>\$6,200</u>			<u>\$30</u>		+	<u>\$6,170</u>

This transaction is the reverse of that described in paragraph 8 and results in putting back into capital a part of what was taken out in that transaction.

Summary of Transactions. These transactions may be summarized as follows:

- | | | |
|---|---|--|
| Transactions
which do not
affect capital. | { | 2. Transactions in which one asset is exchanged for another of equal value. (Exchange of assets.) |
| | | 3. Transactions in which the increase in an asset is equal to the increase in liability. (Purchase on credit.) |
| | | 4. Transactions in which the increase in one liability is equal to the decrease in another liability. (Exchange of liabilities.) |
| | | 5. Transactions in which a decrease in assets is equal to the decrease in liabilities. (Liability paid.) |

- | | | |
|---|---|--|
| Transactions
which do
affect capital. | { | 1. Transactions in which the assets increase and the capital increases in like amount. (Investment by owner.) |
| | | 6. Transactions in which the assets decrease with a corresponding decrease in capital, the liabilities remaining unchanged. (Expense. Services purchased for cash.) |
| | | 7. Transactions in which the assets increase with a corresponding increase in capital, the liabilities remaining unchanged. (Income. Increase in assets through income.) |
| | | 8. Transactions in which the capital is decreased and the liabilities increased a like amount, the assets remaining unchanged. (Expense. Services purchased on credit.) |
| | | 9. Transactions in which the capital is increased and the liabilities decreased, the assets remaining the same. (Reduction of liability.) |

Note: In this classification only actual transactions between two parties are considered.

DETERMINATION OF NET PROFIT AND LOSS FROM ANALYSIS OF CAPITAL

Summary of John Black's Transactions. The capital of John Black at the time of beginning the business was \$6,000, that is (Capital I or C_1).

ASSETS		=	LIABILITIES		+	CAPITAL	
Cash	\$6,000			000		John Black	\$6,000

His capital after the transactions given on the previous pages is \$6,170, that is (Capital II or C_2).

ASSETS		=	LIABILITIES	+	CAPITAL
Cash	\$5,380		Evening Times Co.	\$30	John Black \$6,170
Furniture	500				
Office appliances	320				
Total	<u>\$6,200</u>			<u>\$30</u>	<u>+</u> <u>\$6,170</u>

His capital, therefore, has been increased by these transactions to the extent of \$170, obtained by subtracting from the capital at the end of the period, \$6,170, the capital at the beginning of the period, \$6,000 ($C_2 - C_1 = \170).

This increase in capital is called the *net income* (or *net profit*).

Net income or *net profit* may, therefore, be defined as the net increase of capital through operations, during a period of time.

Net loss may be defined as the net decrease of capital through operations, during a period of time.

The procedure in determining net profit or loss may be expressed in the following manner:

Net Profit = Capital at end of the period less capital at beginning of period ($C_2 - C_1$).

Net Loss = Capital at beginning less capital at end of the period ($C_1 - C_2$).

Changes in Capital Other than Through Operations. Net profit or loss is the net increase or net decrease of capital during a period through earnings or losses from operation. If the capital has changed because of additional investments or drawings by the proprietor, these changes must be adjusted before the above equations can be used, since they do not represent earnings or losses from operations.

Net Profit or Loss Derived from the Difference Between Income and Expense. John Black from transactions recorded thus far has received income from commissions of

\$300. In order to produce this income, he paid \$100 to employees for their services and engaged to pay \$60 for advertising. The amount of the cost of advertising was later corrected and reduced to \$30. He had left, after deducting these expenses, \$170 of the income he had earned. This amount corresponds to the net profit obtained in the formula: Capital at end less Capital at beginning equals Net Profit.

The net profit derived from the difference between income and expense may be expressed by the following equation:

Total Income	—	Total Expenses	=	Net Profit
\$300	—	\$130	=	\$170

If the total expenses exceed the total income, obviously the result is a net loss.

This last method shows not only the amount of net profit, but in addition, explains how the net profit was made.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. A business transaction is defined as an exchange of values. Cite several business transactions.
2. In what ways may transactions affect the balance sheet equation?
3. What is the object of the exchanges of values made through business transactions? Illustrate.
4. Explain and illustrate the following statement: "The total of the assets owned must equal the total of the creditors' and proprietor's interest in those assets."

5. Explain the following propositions and show an instance of each:
 - (a) An increase in assets results in an equal and corresponding increase in the interests in the assets owned.
 - (b) A decrease in assets results in an equal and corresponding decrease in the interests in the assets owned.
 - (c) A decrease of proprietary interest results in an increase in liabilities if there is no change in assets.
6. What transactions have no effect on capital? Name several.
7. Name several transactions which do affect capital.
8. How may a proprietor increase his capital?
9. How many different types of changes may take place in the three classes of items in the balance sheet equation? List them.
10. Name several transactions resulting in increases in assets and show all possible opposite effects.
11. Give an illustration of each of the following types of business transactions, applying the illustration to transactions which might be made by you personally.
 - (a) A transaction in which your total assets remain the same and with no increase or decrease of capital or liabilities.
 - (b) A transaction in which your assets increase and the liabilities increase by a corresponding amount. (No change in capital.)
 - (c) A transaction in which your assets decrease with a corresponding decrease in the liabilities. (No change in capital.)
 - (d) A transaction in which your assets increase with a corresponding increase in capital. (No changes in liabilities.)
 - (e) A transaction in which your assets decrease with a corresponding decrease in capital. (No change in liabilities.)
12. Define an expense. An income.

13. What is net profit (or net income)?
14. What is net loss (or net expense)?
15. Knowing the capital at the beginning of a period and the capital at the end of a period, how may the result of the transactions for the period be determined?
16. Would the net profit determined by subtracting the capital at the beginning of the period from the capital at the end of the period give the proprietor all the information he needs in regard to his business? Why?
17. (a) How may the profit or the loss be found otherwise than by finding the difference between the capital at the beginning and at the end of the period?
(b) What value is attached to this method of determining profit or loss?
(c) What essential relationship exists between the profit or loss found by both methods?
18. Explain what additional information is shown by the second method which is not shown in the equation method.

CHAPTER III

ACCOUNTS: THEORY OF DEBIT AND CREDIT

EVERY business enterprise should keep records to show:

1. The kind and monetary value of the property owned. (Assets.)
2. The interests of creditors in the assets. (Liabilities.)
3. The interest of the owners in the assets. (Capital.)
4. The changes in the interest of the owners, due to business transactions or other causes. (Expense and income.)

Accounts. In recording this information, classifications of values, called *accounts*, are used.

An *account* may be defined as a *collection of information under a specific title regarding the value of any asset, liability, or capital element of a business*. In other words, accounts are mediums through which the information used in determining the net worth and the results of operations of an enterprise is obtained.

Professor Charles E. Sprague, in his *Philosophy of Accounts*, defines an account as follows: "An account is a systematic record of financial facts showing increasing and decreasing tendencies leading to a conclusion."

Professor William M. Cole, in his *Fundamentals of Accounting*, says: "In a specific sense, an account is a classified arrangement of all the financial items pertaining to one kind of information about a business, and that information may be concerned with the relations of the business to an individual, as the proprietor or a lender, or it may be concerned with property, as cash or merchandise."

Classification of Accounts. Accounts are classified according to the types of information recorded therein as follows:

Asset accounts record property values and rights owned.

Liability accounts record creditors' interests in the assets.

Capital accounts record owners' interests in the assets.

Expense accounts record during an accounting period the decreases in capital.

Income accounts record during an accounting period the increases in capital.

Accounts are customarily classified into two groups:

1. Real accounts (assets, liabilities, and capital).
2. Nominal accounts (expense and income).

Real accounts — namely, assets, liabilities, and capital — are those used to reflect the values of the assets and the interests therein. The asset accounts record the real values owned; the liability accounts represent the actual value of the creditors' interests in the assets; the capital accounts represent the value of the proprietor's interest in the assets.

Nominal accounts — namely, expense and income — are those used to explain how and why the capital has increased or decreased during a period of operation. Income accounts record the sources and amounts of the increases in capital during the accounting period, while the expense accounts record expenditures made to produce the income. They, therefore, supplement the capital account.

The income and expense accounts are called nominal because they do not represent actual values owned or interests in the actual values, but merely show amounts of income and of the expenditures made directly to produce this income. They are, therefore, accounts of a statistical

nature, kept during the period for informational purposes, and are at the close of the period merged with or closed into the capital account.

Chart of Accounts. A list of accounts typical of a commission business is illustrated in the following chart.

CHART OF ACCOUNTS — SERVICE BUSINESS

No.	REAL ACCOUNTS		NOMINAL ACCOUNTS	
	Assets	Liabilities and Capital	Expense	Income
1	Cash		Salaries and Wages	Commission Income
2	Notes Receivable	Notes Payable	Rent	
3	Accounts Receivable (Separate account for each person or firm)	Accounts Payable (Separate account for each person or firm)	Office Supplies	
4			Telephone and Telegraph	
5				Interest Income
6	Furniture and Fixtures		Miscellaneous Expense	
7	Office Appliances	Proprietor's Capital Account (Name of owner)		
8			Interest Expense	
9	Office Supplies on Hand			

A chart of accounts is a summary showing the names of all the accounts of a business enterprise arranged in columns headed Assets, Liabilities and Capital, Expense, and Income. It is important in selecting the names or titles of accounts that each title be specific and clearly descriptive of the information that is contained in the account.

The information recorded under the account titles, as listed in this chart, is explained as follows:

Cash records money paid or received in the form of coin, currency, checks, post office money order, express money order, accepted sight drafts, or anything which is accepted at face value as the equivalent of cash.

Notes Receivable records promissory notes which are received by the business, payable to the business by other parties.

Accounts Receivable is a general title referring to personal accounts with individuals or firms who are indebted to the business. A separate account under the name of each debtor is kept to record the dealings of the business with this particular debtor.

Furniture and Fixtures records the value of all desks, chairs, filing cabinets, and other furniture used in the office.

Office Appliances records the value of all typewriters, adding machines, check writers, time clocks, and any other mechanical equipment used in the office.

Office Supplies on Hand records the value of any paper or stationery on hand unused in the office at the date of a balance sheet.

Notes Payable records promissory notes, given and signed by the proprietor, payable by the business to others.

Accounts Payable is a general title referring to personal accounts with creditors. A separate account is kept for each creditor, recording the dealings of the business with this creditor.

Proprietor's Capital records the proprietor's interest in the assets.

Salaries and Wages records the amounts paid employees or agents for services rendered.

Rent records the amounts paid for the space occupied in property of other persons and used in carrying on the business.

Office Supplies records the value of the supplies purchased which have been used in the office during the period.

Telephone and Telegraph records the payments for telephone and telegraph service received.

Interest Expense records the amounts paid for the use of money borrowed by the business.

Miscellaneous Expense records items of expense too insignificant in amount to classify as separate accounts.

Commission Income records the amounts earned in selling goods of others or the rendering of some service.

Interest Income records the amounts received for the use of money loaned by the business to others.

The Ledger Account Form. A record or book in which accounts are kept is called a *ledger*.

For the accumulation of information relating to a particular account a page of the ledger is reserved by writing the name of the account at the top of the page.

There are many forms of ledger rulings; the standard form of ledger ruling is shown below:

Name of Account							
Date	Explanation	L.F.	Amount	Date	Explanation	L.F.	Amount
	Debit Side				Credit Side		

A skeleton ledger account form, often used in demonstrations, omits all the vertical rulings except the center line.

Name of Account		
Debit Side	← →	Credit Side

Parts of a Ledger Account. Ledger accounts are composed of the following parts:

1. A title or name.
2. A debit side. This consists of explanatory columns and an amount column in which is entered the debit.
3. A credit side. This consists of explanatory columns and an amount column in which is entered the credit.
4. The difference or balance. This is the excess of one side over the other side.

Debit and Credit. Every account has two sides, a left side and a right side, which are customarily referred to as the *debit and credit sides*. The left side is called the debit side and the right side is called the credit side.

Confusion frequently arises due to the fact that either of these words may be used as a noun, adjective, or a verb, as illustrated in the following:

1. *A debit* (used as a noun) is a value, expressed in money, which is entered or is to be entered, on the *left* side of an account.
2. *The debit side* (used as an adjective) refers to the left side of an account in which debits are entered.
3. *To debit* (used as a verb) an account is to place or indicate an amount which is to be placed on the debit side of an account.

The word *credit* is used in a similar manner.

1. *A credit* (used as a noun) is a value, expressed in

money, which is entered or is to be entered, on the *right* side of an account.

2. *The credit side* (used as an adjective) refers to the right side of an account in which credits are entered.
3. *To credit* (used as a verb) an account is to place the amount or indicate that the amount is to be placed on the credit side of an account.

Dr. and Cr. The Dr. and Cr. abbreviations are commonly used for debit and credit. Dr. is also the abbreviation for debtor, and Cr. is the abbreviation for creditor. Wherever the abbreviations Dr. and Cr. are used in this book they refer to the words debit or credit.

Theory of Debit and Credit. The basic classification of accounts is the real or the balance sheet accounts. These accounts were used in the balance sheet equation, which may be expressed as follows:

Assets	=	Liabilities
		+
		Capital

In this form of the balance sheet equation a skeleton ledger account is used; the assets being placed on the left or debit side, and the liabilities and capital on the right or credit side. This arrangement of the balance sheet equation emphasizes the fact that asset account balances are always debits and that liability and capital account balances are always credits.

The Ledger as a whole may thus be considered as an equation having the asset values on the left side and the liability and capital values on the right side. The *increase or positive side* of an *asset account* is the *left or debit side*. The *increase or positive side* of a *liability or capital account* is the *right or credit side*. This theory is used in the record-

ing of the property with which a business is started and the recording of the subsequent transactions involving this property. In other words, assets or increases in assets are recorded as debits in the asset accounts. Liabilities and capital or increases in these elements are recorded as credits to these accounts.

In the operation of a business enterprise there are decreases in the three elements (assets, liabilities, and capital) as well as increases. Provision must therefore be made for recording the decreases in these accounts. This is accomplished by giving each of the types of accounts in the balance sheet equation a decrease side as well as an increase side. The balance sheet equation may now be expressed vertically as follows:

ASSETS	
Increase	Decrease
Debit	Credit
+	-
=	
LIABILITIES	
Decrease	Increase
Debit	Credit
-	+
+	
CAPITAL	
Decrease	Increase
Debit	Credit
-	+

It should be observed that the fundamental balance sheet equation is unchanged, as the asset balances will always appear on the debit or left side and the liability and capital balances on the credit or right side. The right side of an asset account merely represents a decrease or a subtraction, likewise the left side of a liability and capital account represents a decrease or a subtraction. In other words, decreases in assets are recorded as credits to the asset accounts. Decreases in liabilities and capital are recorded as debits to these accounts.

Rule for Debit and Credit. From the principles explained above under *Theory of Debit and Credit*, the following rule, frequently called the *debit and credit rule*, is formulated:

Debit the appropriate account for:

1. An increase in an asset.
2. A decrease in a liability.
3. A decrease in capital.

Credit the appropriate account for:

1. An increase in a liability.
2. An increase in capital.
3. A decrease in an asset.

Application of Debit and Credit Rule to Expense and Income Accounts. As explained previously, expense accounts are used to record decreases in capital during an accounting period and income accounts record the increases in capital. They are temporary capital accounts used during an accounting period to record the decreases and increases in capital. Expense accounts are, therefore, debited for any expenditure resulting in a decrease in capital and income accounts are credited for any increase in capital resulting from operations.

DEBIT AND CREDIT RULE FOR EACH CLASS OF ACCOUNTS

The rule for debit and credit may be restated as follows:

Asset accounts are { debited when assets are purchased or received;
credited when assets are sold or disposed of.

Liability accounts are { credited when liabilities are incurred;
debited when liabilities are paid.

Capital accounts are { credited for investments in the business and net profits;
debited for withdrawals and net losses.

Expense accounts are { debited when expenses are paid or incurred;
credited occasionally for reductions in the amount first entered;

Income accounts are { credited when income is earned;
debited for any reduction of income earned.

It should be noted that the first entry in any account should always be on the positive or increase side. All subsequent entries will be on the same side if an addition to the account value occurs, or on the opposite or decrease side when a decrease or subtraction is made. When the negative side equals the positive side, there is no excess or balance and the account is closed.

Balances of all accounts are normally on the positive or increase side.

Change in Classification. A particular account may change its classification as a result of certain transactions or other causes, such as fire, theft, wear and tear, etc. If an account classified as a liability should have a debit balance the account is no longer a liability. It has changed its classification and has become an asset or an expense.

This feature of account changes will be developed as the work progresses.

Summary of Relationship of Accounts to Balance Sheet. The balance sheet equation, that is, Assets = Liabilities + Capital, may be graphically illustrated in its connection with ledger accounts as follows:

BALANCE SHEET SUMMARY OF RULES FOR DEBIT AND CREDIT

DEBIT		=	=	CREDIT	
ASSET ACCOUNTS		=	=	LIABILITY ACCOUNTS	
Increase	Decrease			Decrease	Increase
Debit	Credit			Debit	Credit
+	—			—	+
				<i>plus</i>	
				OWNER'S CAPITAL ACCOUNTS	
				Decrease	Increase
				Debit	Credit
				—	+
				EXPENSE	INCOME
				Increase	Decrease
				Debit	Credit
				+	—
				—	+

Note: It should be noted that the left side of every account is the debit side and the right side of every account is the credit side, yet the increase side may be the left or right side, depending upon the classification of the account. The same is true of the decrease side.

Application of Rules for Debit and Credit. The following illustrations show the application of the rules for debit and credit to the transactions of John Black.

ILLUSTRATION 1

John Black invested \$6,000 in a commission business.

		REASONS
Debit — Cash	\$6,000	Increase of asset — Cash
Credit — John Black, Capital	6,000	Increase of capital of John Black in the business

This may be summarized in skeleton account form as follows:

CASH (<i>Asset</i>)		JOHN BLACK, CAPITAL	
(1)	\$6,000	(1)	\$6,000

ILLUSTRATION 2

John Black buys office furniture for \$500 and pays cash.

		REASONS
Debit — Furniture and Fixtures	\$500	Increase of asset — Furniture and Fixtures
Credit — Cash	500	Decrease of asset — Cash

This may be summarized in skeleton account form as follows:

FURNITURE AND FIXTURES (<i>Asset</i>)		CASH (<i>Asset</i>)	
(2)	\$500	(1)	\$6,000
		(2)	\$500

The numbers (1), (2), etc., are used only to assist in tracing the entries.

Note that the asset, Cash, has been decreased \$500, leaving a balance value of \$5,500 in the Cash account.

ILLUSTRATION 3

John Black buys an adding machine and a typewriter for \$320 from Union Office Appliance Company and agrees to pay for them in 30 days.

REASONS

Debit — Office Appliances	\$320	Increase of asset — Office Appliances
Credit — Union Office Appliance Company	\$320	Increase of liability — Union Office Appliance Company

This may be summarized in skeleton account form as follows:

OFFICE APPLIANCES (Asset)		UNION OFFICE APPLIANCE COMPANY (Liability)	
(3)	\$320	(3)	\$320

ILLUSTRATION 4

John Black gives to the Union Office Appliance Company a written promise to pay (called a *note payable*) for the goods purchased for \$320, payable 30 days from the date when the note is issued.

REASONS

Debit — Union Office Appliance Company	\$320	Decrease of liability — Union Office Appliance Company
Credit — Notes Payable	320	Increase of liability — Notes Payable

This may be summarized in skeleton account form as follows:

UNION OFFICE APPLIANCE COMPANY (<i>Liability</i>)				NOTES PAYABLE (<i>Liability</i>)	
(4)	\$320	(3)	\$320	(4)	\$320

ILLUSTRATION 5

John Black pays the Union Office Appliance Company \$320 for the note given them, the note now being due.

REASONS

Debit — Notes Payable	\$320	Decrease of liability — Notes Payable
Credit — Cash	320	Decrease of asset — Cash

This may be summarized in skeleton account form as follows:

NOTES PAYABLE (<i>Liability</i>)				CASH (<i>Asset</i>)	
(5)	\$320	(4)	\$320	(1)	\$6,000
				(2)	\$500
				(5)	320

ILLUSTRATION 6

John Black pays cash, \$100, for salaries of employees for the week.

REASONS

Debit — Salaries	\$100	Decrease of capital through expense
Credit — Cash	100	Decrease of asset — Cash

This may be summarized in skeleton account form as follows:

SALARIES (<i>Expense</i>)		CASH (<i>Asset</i>)	
(6)	\$100	(1)	\$6,000
		(2)	\$500
		(5)	320
		(6)	100

ILLUSTRATION 7

John Black receives a check for \$300 from the Home Manufacturing Company in payment for commission earned by him on the goods sold to A. L. Doane.

REASONS

Debit — Cash	\$300	Increase of asset — Cash
Credit — Commission Income	300	Increase of capital through income

This may be summarized in skeleton account form as follows:

CASH (<i>Asset</i>)		COMMISSION INCOME (<i>Income</i>)	
(1)	\$6,000	(2)	\$500
(7)	300	(5)	320
		(6)	100
		(7)	\$300

ILLUSTRATION 8

John Black inserts an advertisement in the *Evening Times* costing \$60, payable on the tenth of the following month.

REASONS

Debit — Advertising	\$60	Decrease of capital through expense
Credit — Evening Times Company	60	Increase of liability — Evening Times Company

This may be summarized in skeleton account form as follows:

ADVERTISING (<i>Expense</i>)		EVENING TIMES COMPANY (<i>Liability</i>)	
(8)	\$60	(8)	\$60

ILLUSTRATION 9

The Evening Times Company cancelled one half of their bill of \$60 against John Black on the representation of Mr. Black that the advertisement had certain defects.

REASONS

Debit — Evening Times Company	\$30	Decrease of liability — Evening Times Company
Credit — Advertising	30	Increase of capital through decrease of liability

This may be summarized in skeleton account form as follows:

EVENING TIMES COMPANY (<i>Liability</i>)				ADVERTISING (<i>Expense</i>)			
(9)	\$30	(8)	\$60	(8)	\$60	(9)	\$30

These several summaries show the application of the theory of debit and credit to certain business transactions. The next chapter will develop the method of recording the results of such analysis in simple bookkeeping records.

Equality of Debit and Credit. Referring to the preceding illustrations, it will be noted that in every transaction the amount of the debit equals the amount of the credit. It may be stated, therefore, as a universal rule, that in every transaction the debit or the sum of the debits equals the credit or the sum of the credits.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What information should the records of every business enterprise show?
2. Define an account.
3. Distinguish between real and nominal accounts.
4. What is a chart of accounts? How is it prepared?
5. Of what advantage is this chart?
6. Name and explain several asset accounts.
7. Name and explain several liability accounts.
8. Name and explain several capital accounts.
9. Describe the standard ledger account form.
10. Name and explain the parts of an account.
11. What is a debit? A credit?
12. Why are asset account balances always debits and liability and capital account balances always credits?
13. State the rule for debit and credit of asset accounts.
14. State the rule for debit and credit of liability and capital accounts.
15. State the rule for debit and credit of expense accounts.
16. State the rule for debit and credit of income accounts.
17. What would be your conclusion if you should find an asset account with a credit balance? A liability account with a debit balance? A capital account with a debit balance?

CHAPTER IV

APPLICATION OF THE THEORY OF DEBIT AND CREDIT. DOUBLE ENTRY BOOKKEEPING

Bookkeeping. The essential financial information required concerning a business may be summarized as follows:

1. Information as to the assets owned and the interests therein. (Shown by the real accounts.)
2. Information regarding the results of operating, that is, profit and loss. (Shown by the nominal accounts.)

The accounts described in the preceding chapter supply the basis from which this information is derived. It is the purpose of this chapter to show how the principles explained in the preceding chapters are applied in actual bookkeeping procedure; that is, to show how this essential information is accumulated in the accounts.

Double Entry Bookkeeping. The maintaining of a system of records in a business enterprise, where the principle of equal debits and equal credits is observed, is called *double entry bookkeeping*.

There are two main classes of records in a double entry system of bookkeeping.

1. Journals (books of original entry).
2. Ledgers (books in which the accounts are kept).

A book, in the general sense, usually means a collection of pages bound together under one cover. But in accounting it includes, as well, cards retained in files or drawers, loose-leaf pages kept in binders, or, in fact, any collection of forms or papers containing information of a specific type.

The Journal. The Journal is used to record transactions as they occur. The record of a business transaction in the Journal is called a *journal entry*. Usually the first entry in a Journal is the record of the value and kind of property with which the business is started and the interests in this property.

A form of journal entry is shown below:

MODEL JOURNAL ENTRY

October 6, 19—

Cash	200	—		
Commission Income			200	—
Received a check from Jackson & White for commission earned on sale to United Manufacturing Company. 10% of \$2,000.				

Each entry is composed of the following parts:

1. The date of the transaction.
2. The name of the account to be debited and the debit.
3. The name of the account to be credited and the credit.
4. The explanation, or reason for the entry.

Entries are made in the Journal as follows:

1. The date, if it is the first entry on the page, is placed at the top of the page, the month, day and year being written. The date for each subsequent entry is placed in the middle of the line following the previous entry.
2. After the transaction has been analyzed into its debit and credit elements, the name of the account to be debited is written on the first line of the entry and the amount of the *debit* is written on the same line in the *left* or debit money column.

3. The name of the account credited is written on the next line following the debit indented to the right about three quarters of an inch. The amount of the *credit* is written in the *right* or credit money column on the same line with the name of the account to be credited.
4. Below the name of the account credited, a brief clear statement is given of the facts of the transaction which the entry is to record.

Journalizing. The process of analyzing transactions into their debit and credit elements and the recording of the results thereof in a journal is called *journalizing*.

The Ledger. The Ledger is the book in which the accounts of a business are kept. A page or section of the Ledger is reserved for each account and the debits and credits which have been entered in the Journal are transferred to the proper Ledger page or section under the account title.

The Journal provides only for the recording of the debits and credits of transactions as they occur. To obtain the total of the debits or credits or both to a given account, these debits and credits are transferred to the account in the Ledger. The Ledger, therefore, is a book in which the debits and credits as entered in the Journal are summarized according to account titles.

Posting. The process of transferring the debits and credits from the Journal to the proper accounts in the Ledger is called *posting*.

The form and use of columns as they customarily appear on the Ledger page are indicated on the following page.

NAME OF ACCOUNT

DEBIT					CREDIT				
Month	Day	Explanation	Folio	Amount of the Debit	Month	Day	Explanation	Folio	Amount of the Credit

Note: The explanation space in the Ledger is seldom used for the explanation of the entry, as the Journal entry contains all details. The reference page of the Journal found in the folio column is usually sufficient as it indicates where the explanation may be found. (See Model Ledger, pages 62-66.)

Process of Posting. The transferring of the debits and credits from the Journal to the Ledger may be done by either of the following methods:

1. Post all the debits from the Journal to the debit side of the proper accounts in the Ledger and then post all the credits to the credit side of the proper accounts in the Ledger.
2. Post the debit and credit of each transaction in the Journal to the debit and credit of the proper accounts in the Ledger.

Posting is essentially a mechanical operation and that method should be used which insures the greatest accuracy, with a minimum expenditure of time. It is best to use only one method so that the process will become, in time, practically automatic.

One suggestion which may reduce errors in posting is to post the *amount* from the Journal to the proper side of the Ledger account first. The amount is the most essential, and in posting it first the possibility of confusing figures is reduced.

After carrying the amount to be posted to the proper side of the Ledger account, the initial and page of the Journal

from which the posting is done is put in the Folio column, and the year, month, and day are placed in the Date columns. Then in the Journal the page of the Ledger to which the item is transferred is entered in the Folio column to the left of the item posted.

It is very essential that the page of the Journal, from which the posting is made, be entered in the Folio column of the Ledger and that the page of the Ledger to which the item has been posted be entered in the Folio column of the Journal. This provides a cross-reference which saves time in cases where any question arises regarding either the entry or the posting.

When the transfer of each debit or credit is made and the Folio columns recorded, it is always advisable to refer from the Ledger to the Journal to be sure that the figures are properly transferred. This precaution may save considerable time afterward, since the work of locating errors in posting may consume as much or more time than the posting itself.

Posting of Model Journal. On the following pages the entries from the Model Journal illustrated on pages 56-61 are posted to a Model Ledger. In this Model Ledger, several accounts are opened on a page solely as a matter of convenience. In practice, usually not more than one account is opened on a page.

Order in which Accounts are Opened. The accounts in the Model Ledger are opened according to the classification as shown by the Chart of Accounts on page 55, in the following order: (1) Assets, (2) Liabilities, (3) Capital, (4) Expense, and (5) Income. This arrangement is desirable because the accounts showing condition are in one section, and the accounts showing the results of operations are in another section of the Ledger.

Books of Original Entry and Final Entry. The Journal, inasmuch as it is the book in which the transactions are entered as they occur, is called a book of *original entry*.

The Ledger, inasmuch as it is the book to which the debits and credits are finally transferred, is called a book of *final entry*.

The Journal is the original record of the transactions and as such is recognized by the courts as evidence proving or disproving claims. The Ledger, on the other hand, is merely a classified transcript of the debits and credits from the Journal, and has very little value, of itself, in proving claims.

Illustrative Journal. On pages 56-61, a model Journal is written from transactions taken from the business of John Black, who, as stated in an earlier chapter, started business for himself selling electrical refrigerators on a commission basis. He is to be paid 10 per cent commission on all sales; the commission becoming due to him on the date of the shipment of the goods by the manufacturer to the customer. The manufacturer sends a copy of the customer's invoice to John Black to inform him of the shipment and the amount of the commission due to him.

In journalizing the transactions, the accounts as shown in the Chart of Accounts on page 55 will be used.

JOHN BLACK

CHART OF ACCOUNTS

REAL		NOMINAL	
ASSETS	LIABILITIES AND CAPITAL	EXPENSE	INCOME
Cash	Evening Times Co.	Salaries	Commission
Atlas Mfg. Co.	Trade Journal, Inc.	Traveling Ex-	Income
Mecca Mfg. Co.	Union Office Appli-	penses	
Furniture and	ance Co.	Stationery and	
Fixtures	United Supply Co.	Supplies	
Office Appliances		Advertising	
		Rent	
	CAPITAL		
	John Black, <i>Capital</i>		

TRANSACTIONS OF JOHN BLACK

Note: According to agreement, commissions are considered earned when the goods are shipped; therefore, a record will be made on the books, of the commissions due at the time of shipment of the goods. ▽

July 1, 1919 John Black invests \$6,000 in the business

 The debit is to Cash. (Increase in asset.)

 The credit is to Capital. (Increase in capital.)

- 2 Pays the rent for the month of July in cash, \$120.

 The debit is Rent. (Decrease of capital.)

 The credit is Cash. (Decrease of assets.)

- 3 Pays cash \$500 for office desks, chairs, filing cabinets, purchased from Acme Company.

 The debit is Furniture and Fixtures. (Increase of assets.)

 The credit is Cash. (Decrease of assets.)

- 5 Buys a typewriter and an adding machine for \$320 from the Union Office Appliance Company and agrees to pay for the same in 20 days.

 The debit is Office Appliances. (Increase of assets.)

 The credit is Union Office Appliance Company. (Increase of liabilities.)

- 6 Buys stationery and supplies from the United Supply Company for \$62.50. Terms: on account 30 days.

 The debit is Stationery and Supplies. (Decrease of capital.)

 The credit is United Supply Company. (Increase of liabilities.)

MODEL JOURNAL, PAGE 1

July 1, 19—

John Black has this day started business for himself selling refrigeration plants for a group of manufacturers on a commission basis. He has rented offices at 93 Boylston Street, Boston, and engaged a bookkeeper, clerk, and two salesmen. His investment is recorded as follows:					
Cash	*1	6000	—		
John Black — Capital	4			6000	—
To record the investment by Black of cash, \$6,000.					
2					
Rent	5	120	—		
Cash	1			120	—
Paid the rent for the month of July.					
3					
Furniture and Fixtures	2	500	—		
Cash	1			500	—
Paid cash for office furniture bought from Acme Co.					
5					
Office Appliances	2	320	—		
Union Office Appliance Co.	3			320	—
Bought a typewriter and an adding machine from the above company and have agreed to pay for same in 10 days.					
6					
Stationery and Supplies	5	62	50		
United Supply Co	3			62	50
Bought stationery and office supplies on account, 30 days.					

*Note: The function of the figures in this column is explained under Posting on page 52 in this chapter.

- July 9 Pays cash for salaries of employees for week, \$100.
The debit is Salaries. (Decrease of capital.)
The credit is Cash. (Decrease of assets.)
- 10 Receives a bill from Evening Times Company for an advertisement inserted in the *Evening Times*. Amount of bill \$60. Terms: net 30 days.
Note: The term "net 30 days" means that the bill is payable in 30 days and no discount is allowed.
The debit is Advertising. (Decrease of capital.)
The credit is Evening Times Company. (Increase of liabilities.)
- 12 Receives a check for \$300 from Home Manufacturing Company in payment of commission on sale to A. L. Doane. A copy of the invoice sent to Doane accompanies the check.
The debit is Cash. (Increase of assets.)
The credit is Commission Income. (Increase of capital.)
- 15 Pays cash for salaries of employees for week, \$100.
The debit is Salaries. (Decrease of capital.)
The credit is Cash. (Decrease of assets.)
- 18 Receives a check for \$100 from the Moore Company in payment of commission on sale to D. R. Blood. A copy of the invoice sent to D. R. Blood accompanies the order.
The debit is Cash. (Increase of assets.)
The credit is Commission Income. (Increase of capital.)
- 22 Receives from Mecca Manufacturing Company a copy of the invoice of the goods shipped to L. D. Krebs & Co. The commission on this sale is \$240, which is to be paid by Mecca Manufacturing Company.
The debit is Mecca Manufacturing Company. (Increase of assets.)
The credit is Commission Income. (Increase of capital.)

MODEL JOURNAL, PAGE 2

July 8, 19—

Salaries	4	100	—	
Cash	1		100	—
Paid salaries for the week.				
10				
Advertising	5	60	—	
Evening Times Company	2		60	—
Insertion of advertisement in				
Evening Times payable				
8/1/19—				
12				
Cash	1	300	—	
Commission Income	5		300	—
Check received from Home				
Mfg. Co. in payment of com-				
mission on goods sold to A. L.				
Doane & Co				
15				
Salaries	4	100	—	
Cash	1		100	—
Paid salaries for week.				
18				
Cash	1	100	—	
Commission Income	5		100	—
Check received from Moore Co.				
in payment of commission on				
goods sold to D. R. Blood.				
22				
Mecca Mfg. Co.	1	240	—	
Commission Income	5		240	—
To record commission due us				
from Mecca Mfg. Co. on goods				
shipped to L. D. Kreb & Co.				

July 22 Pay cash for salaries of employees for week, \$100.

The debit is Salaries. (Decrease of capital.)

The credit is Cash. (Decrease of assets.)

25 Pays cash to Union Office Appliance Company in full of account, \$320.

The debit is Union Office Appliance Company. (Decrease of liabilities.)

The credit is Cash. (Decrease of assets.)

26 Receives from Atlas Manufacturing Company a copy of invoice of goods shipped to A. L. Macon. The commission on the sale is \$400, which is to be paid in 10 days. (Entry same as 12th.)

29 Pays cash for salaries of employees for week, \$100.

The debit is Salaries. (Decrease of capital.)

The credit is Cash. (Decrease of assets.)

30 Receives a check for \$240 from the Mecca Manufacturing Company in payment of commission due on the sale to L. D. Kreb & Co.

The debit is Cash. (Increase of assets.)

The credit is Mecca Manufacturing Company. (Decrease of assets.)

31 Receives a bill from the Trade Journal, Inc., for an advertisement inserted in the *Trade Journal*; amount of bill \$80. Terms: net cash.

Note: Terms net cash means that the bill is payable in the future, time varies from 10 to 30 days, and there is no discount.

The debit is Advertising. (Decrease of capital.)

The credit is Trade Journal. (Increase of liabilities.)

31 Pays cash for traveling expenses \$75.80.

The debit is Traveling Expenses. (Decrease of capital.)

The credit is Cash. (Decrease of assets.)

MODEL JOURNAL, PAGE 3

JULY 22, 19—

Salaries	4	100	—	
Cash	1		100	—
Paid salaries for week.				
25				
Union Office Appliance Co.	3	320	—	
Cash	1		320	—
Payment in full for goods purchased on the 5th.				
26				
Atlas Mfg. Co.	1	400	—	
Commission Income	5		400	—
To record commission due us on goods shipped to A. L. Macon.				
29				
Salaries	4	100	—	
Cash	1		100	—
Paid salaries for week.				
30				
Cash	1	240	—	
Mecca Mfg. Co.	1		240	—
In payment for commission on sale to L. D. Kreb & Co.				
31				
Advertising	5	80	—	
Trade Journal, Inc.	3		80	—
For insertion of advertisement in the Trade Journal.				
31				
Traveling Expense	4	75	80	
Cash	1		75	80
Traveling expenses for month.				

MODEL LEDGER, PAGE 1

CASH

19—						19—					
July	1		J 1	6000	—	July	2	J 1	120	—	
	12		J 2	300	—		3	J 1	500	—	
	18	6640 —	J 2	100	—		8	J 2	100	—	
		1415.80						J 2	100	—	
	30	5224.20	J 3	240	—		15	J 2	100	—	
				6640			22	J 3	100	—	
							25	J 3	320	—	
							29	J 3	100	—	
							31	J 3	75 80		
									1415 80		

ATLAS MANUFACTURING COMPANY

19—											
July	26		J 3	400	—						

MECCA MANUFACTURING COMPANY

19—						19—					
July	22		J 2	240	—	July	30	J 3	240	—	

JOHN BLACK, CAPITAL

[illegible]

STOCKS									
19									
July	8	J	2	100	—				
	15	J	2	100	—				
	22	J	3	100	—				
	29	J	3	100	—				

19— July	31	J 3	75 80							
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STATIONERY AND SUPPLIES

[illegible][illegible]

19— July	2		J 1	120 —						
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[illegible]

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. What two kinds of information are essential about the financial condition of a business? What mediums are used to assemble this information?
2. What is double entry bookkeeping?
3. What are the two main classes of records in a bookkeeping system?
4. The first step, in securing proper accounting for a business is to record the value of the property and the interests in the property with which the business is started. Explain the necessity of the step.
5. Describe the form of a Journal entry.
6. Name the parts of a Journal entry.
7. Describe the ruling of a Journal page.
8. Describe in order the successive steps in making an entry in the Journal.
9. Define journalizing.
10. Does the entry in the Journal constitute a complete record of the transaction?
11. What is the function of the Ledger?
12. Describe a Ledger page and explain the use of each column.
13. Define and describe the process of posting.
14. What are two methods of doing the posting?
15. What is the necessity of:
 - (a) The folio number in the Ledger, that is, the page of the Journal from which posting is done?
 - (b) The folio number in the Journal, that is, the page of the Ledger to which the posting is done?
16. The Journal is called a book of *original entry* and the Ledger a book of *final entry*. Explain the significance of these two names.

CHAPTER V

TRIAL BALANCE

Trial Balance. In posting the entries from the Journal to the Ledger, the debit amount in the Journal was posted to the debit side of the proper Ledger account, and the credit amount in the Journal was posted to the credit of the proper Ledger account. Inasmuch as the debit amount and the credit amount in an entry are equal, the posting of an entry results in a debit and a credit in the Ledger which are equal. Therefore, the sum of all the debits in the Ledger resulting from the posting of the debits from the Journal must be equal to the sum of all the credits in the Ledger resulting from the posting of the credits from the Journal.

To test this equality of the debits and credits in the Ledger, an abstract may be taken of the Ledger accounts, called a *trial balance*. This trial balance may be in either of two forms, namely: a trial balance of totals or a trial balance of balances.

Definition. A *trial balance* is a list of the Ledger accounts showing their debit and credit balances, or totals.

Sometimes a trial balance is defined as follows: A *trial balance* is a summary or abstract of the Ledger.

Trial Balance of Totals. A form of trial balance showing the total debits and total credits to each Ledger account, called a trial balance of totals, is illustrated on page 69. The figures used in this trial balance are taken from the Model Ledger illustrated on pages 62-66.

TRIAL BALANCE OF TOTALS

JOHN BLACK

TRIAL BALANCE, JULY 31, 19—

1	Cash	6640	—	1415	80
1	Atlas Manufacturing Company	400	—		
1	Mecca Manufacturing Company	240	—	240	—
2	Furniture and Furnishings	500	—		
2	Office Appliances	320	—		
2	Evening Times Company			60	—
3	Trade Journal, Inc.			80	—
3	Union Office Appliance Company	320	—	320	—
3	United Supply Company			62	50
4	John Black, Capital			6000	—
4	Salaries	400	—		
4	Traveling Expense	75	80		
5	Stationery and Supplies	62	50		
5	Advertising	140	—		
5	Rent	120	—		
5	Commission Income			1040	—
		9218	30	9218	30

Trial Balance of Balances. The trial balance of balances is the form which makes use of the mathematical principle that "Equals subtracted from equals, the remainders are equal." Therefore, instead of showing the total of the debits and the total of the credits for each account, the smaller total is subtracted from the larger total, and the remainder is shown as a debit or credit in the trial balance. In this form of trial balance, accounts which balance (that is, accounts in which the total of the debits equals the total of the credits) are omitted altogether.

The *remainder* obtained by subtracting the total of the smaller side of the account from the total of the larger side is called the *balance of the account*.

The balance of an account shows the result of the account. It is the answer after subtracting the smaller side from the larger, and shows the net result. If the debit side of the account exceeds the credit, the remainder or balance is called a *debit* balance. If the credit side is the larger, the remainder is called a *credit* balance.

It is the balances of accounts in which proprietors are interested, and therefore a trial balance of balances is the one customarily taken.

A trial balance of balances, taken from the Model Ledger of John Black, is illustrated below.

JOHN BLACK
TRIAL BALANCE OF BALANCES
TRIAL BALANCE, JULY 31, 19—

1	Cash	5224	20		
1	Atlas Manufacturing Company	400	—		
2	Furniture and Furnishings	500	—		
2	Office Appliances	320	—		
2	Evening Times Company			60	—
3	Trade Journal, Inc.			80	—
3	United Supply Company			62	50
4	John Black, Capital			6000	—
4	Salaries	400	—		
4	Traveling Expense	75	80		
5	Stationery and Supplies	62	50		
5	Advertising	140	—		
5	Rent	120	—		
5	Commission Income			1040	—
		7242	50	7242	50

Many trial balances contain totals of certain accounts and balances of all remaining accounts. Frequently trial balances are used which are combinations of both forms

which have been illustrated. Usually the accounts which show the totals are statistical or nominal accounts, which are combinations of two or more accounts that have been merged into one account for convenience in handling. These totals are used for statement purposes as separate items. A trial balance of balances is the form most frequently used.

Value of Trial Balance. A trial balance is a relative proof of the clerical accuracy of the Ledger. It shows that for every *debit* posted to the Ledger, an equal *credit* has been posted. It checks the arithmetical process, but it *does not prove* that each debit and credit has been posted to the correct account, nor that the original debit or credit in the Journal was correct. In spite of these limitations, the trial balance, nevertheless, affords a very valuable check on the accuracy of the posting.

A trial balance, being an abstract of the Ledger, is used as a basis of analysis in determining the condition and operating results of the business.

Location of Errors. If the trial balance does not balance, an error or errors must have been made in:

1. Addition of the amounts on the trial balance itself.
2. Copying the account balances from the Ledger to the trial balance.
3. Addition or subtraction of the debit and credit amounts in the Ledger to obtain the account balances.
4. Posting from the Journal to the Ledger:
 - (a) the omission of the posting of a debit or a credit amount;
 - (b) the posting of both the debit and the credit of an entry to the same side of the Ledger;

- (c) the transposition of the figures in an amount;
- (d) the transplacement of the figures in a debit or credit amount; .
- (e) posting a debit to the credit side of an account, and *vice versa*.

No definite procedure can be prescribed which would be applicable to every case for finding errors. The method of search depends to a considerable degree upon the character of the difference between the two sides of the trial balance.

If the difference between the two sides of the trial balance is \$.01, \$.10, \$1.00, or \$10.00, the error is probably due to a mistake in the addition of the trial balance or in the addition and subtraction of the sides of an account in obtaining the balance. To locate an error of this type, all additions and subtractions must be verified.

If the difference between the two sides is an amount exactly divisible by 9, the error may have resulted from a transposition of figures — that is, writing 35 as 53; or a transplacement of the figures called a “slide” — that is, writing \$25.00 as \$.25 or as \$2.50. Errors of this type may be found by verifying the balances of accounts as copied on the trial balance sheet or by checking postings.

A difference between the two sides of the trial balance may also indicate:

1. The omission of an amount from the trial balance.
2. The omission of a posting.
3. The posting of an amount to the same side of the Ledger twice.
4. The posting of an amount which is a debit in the Journal to the credit side of the Ledger, or *vice versa*.

Errors of this type may be detected by a careful scrutiny of the amounts or by checking *all* the posting.

Procedure when Trial Balance does not Balance. (*To locate errors.*) In taking a trial balance, care should be taken that all additions and subtractions in the accounts on the Ledger or on the trial balance are accurate. Then, if the trial balance is not in balance, *first find out exactly how much it is out of balance.* When the exact error is thus determined, proceed as follows:

1. Look for the amount in the Ledger; it may have been overlooked in transferring the balances to the trial balance.
2. Look for the amount in the Journal; it may not have been posted.
3. Divide by 2 (provided it is an even number) and look for this amount in the Ledger and Journal; it may be an amount posted to the wrong side of an account.
4. Divide the error by 9 to see if there has been a transposition or transplacement of figures. If the error is exactly divisible by 9, then there is probably a transposition or transplacement in figures.

These tests are applicable only in cases of one error. If several errors are made, no test will find them. If errors occur and none of the above tests disclose them, the careful rechecking of *all* posting is necessary.

If the posting is done with sufficient care and the arithmetical calculations are accurate, there should be no trouble in obtaining a trial balance.

Correction of Errors Discovered Before Posting. If discovered before posting, an error in the Journal entry may be corrected:

- (a) by ruling a line through that part of the entry which is wrong, and writing the correct amount or name immediately above it;

- (b) by voiding the entry entirely and making a complete new entry. This may be done on the same page, or on another page on some other date than the date of the error.

Illustration of Method (a). For example, the following entry has been made in the Journal for the payment of a note in cash by William Sanders:

September 29, 19—		
Cash	500.—	
William Sanders		500.—
Received of William Sanders cash in payment of note due to-day.		

This entry is wrong because the credit should be to Notes Receivable account. The entry may be corrected by ruling a line through the name of William Sanders and writing Notes Receivable above it. The entry would then appear as follows:

September 29, 19—		
Cash	500.—	
Notes Receivable		
William Sanders		500.—
Received of William Sanders cash in payment of note due to-day.		

The above correction is all that is necessary if the entry has not been posted.

Illustration of Method (b). The entry may be ruled out entirely and marked "Void," and the correct entry made as follows:

75

Page 6

Received payment in cash
of note due today.

Page 8

Notes Receivable	500.—
------------------	-------

To correct entry made on page 6. William Sanders paid his note in cash.

Correction of Errors Discovered after Posting. Correction of an error discovered after posting may be made by either of the following methods:

- (a) If the entry has been posted, the Journal entry may be corrected in the same manner as in (a) above, but it will also be necessary to rule a line through the posting in the Ledger in William Sanders's account as indicated below, and then post the corrected Journal entry to the Notes Receivable account.

WILLIAM SANDERS							
				19— Sept. 20		J 6	500—

- (b) *Correcting Journal Entry.* This method is preferred when the error has been discovered after the posting is completed. The following entry explains this method:

TRIAL BALANCE

October 15, 19—

Page 8

William Sanders

500.—

Notes Receivable

500.—

To correct entry made September 29 on page 6 in which William Sanders's account was credited in error.

William Sanders's account after posting of above entry will appear as follows:

WILLIAM SANDERS

19— Sept.	1	Balance		600	—	19— Sept.	29		J	6	500	—
Oct	1	Error 9/29 J	8	500	—							

Note that the error will appear on both sides — one balancing off the other.

Error in Amounts. Where figures are recorded in error, the wrong amount may be ruled out and the correct amount written above in both the Journal and the Ledger account, or a correcting Journal entry may be made for the difference between the amount entered and the correct amount. One of these methods should always be used when making corrections in the accounts. Errors should never be corrected by the use of an eraser or ink eradicator. The use of either detracts from the appearance of the books and usually excites suspicion.

Mechanics of Taking a Trial Balance. The proper procedure in taking a trial balance is as follows:

1. After the posting is completed, both sides of each Ledger account should be added where necessary and the totals placed under the last debit and last credit entry in small pencil figures. The smaller

side should then be subtracted from the larger side and the balance written in pencil in the explanation column of the larger side. Refer to the Cash account on page 62 of the Model Ledger for the form.

2. List, on a sheet of journal-ruled paper, the names of the accounts and the balances in the order in which they appear in the Ledger.
3. Add both debit and credit columns. They should be equal.

Ruling Accounts which Balance. Accounts which balance should be ruled to indicate that no further attention need be given the amounts above the ruling. A method of ruling an account with one debit and one credit is illustrated in the following:

JOHN MASON													
19— June	20		J	1	1870	60	19— July	6		J	3	1870	60

A method of ruling an account with an equal number of debits and credits is shown below:

D. B. ROBINSON													
19—						19—							
June	3		J	8	1860	20	June	12		J	11	1860	20
	8		L	11	380	40		18		J	14	380	40
	14		J	13	918	25		24		J	17	918	25

Each of the above debits and credits may be ruled as in John Mason's account or the total may be added and ruled as in the following account.

A method of ruling an account having an unequal number of debits and credits is illustrated below:

19—						19—					
May	6		J 4	960	30	June	10		J 8	2000	—
	24	2430.95	J 6	1470	65		30		J 19	1000	—
June	10		J 8	395	70	July	10		J 22	1728	20
	16		J 13	891	85						
	24	1728.20	J 18	1009	70						
				4728	20					4728	20

Balancing an Account. When there are several debits and credits of unequal amounts in an account, and the balance has been found for the trial balance or other use, it may be desirable to show the resulting balance in one number to save repetition of this work at a later period.

The form on page 79 shows the balancing of an account. Note that

- (a) the balance is entered on the smaller side;
- (b) the account is ruled as in E. J. Hyland's account;
- (c) the balance is entered again below the ruling and on the opposite side from the entry above the ruling.

CASH

19—					19—				
July	1	J 1	6000	—	July	2	J 1	120	—
	12	J 2	300	—		3	J 1	500	—
	18	J 2	100	—		8	J 2	100	—
	30	J 3	240	—		15	J 2	100	—
						22	J 3	100	—
						25	J 3	320	—
						29	J 3	100	—
						31	J 3	75	80
					July	31	Balance	5224	20
			6640	—				6640	—
Aug.	1	Balance	5224	20					

An open account is one which shows a balance remaining in it. A closed account is one which has both sides equal and has no balance. Cash account shown above is an open account. E. J. Hyland account on page 78 is a closed account.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Upon what principle is the trial balance based?
2. Describe:
 - (a) a trial balance of totals;
 - (b) a trial balance of balances.
3. Describe the process of obtaining a trial balance.
4. Does the trial balance reveal the following and why?
 - (a) a debit from the Journal which is not posted;
 - (b) a credit from the Journal which is not posted to the credit side of the Ledger;
 - (c) an entire entry which is not posted at all;
 - (d) a debit from the Journal which is posted to the debit of the wrong account in the Ledger;

- (e) a mistake in addition or subtraction of the debits and credits in the Ledger;
 - (f) the debiting of an asset account in the Journal for an item which should be debited to an expense account;
 - (g) the debiting of an expense account in the Journal for an item which should have been debited to an asset account.
5. Illustrate a correcting Journal entry.
 6. Explain and show how the following types of accounts which balance should be ruled:
 - (a) an account with one debit and one credit;
 - (b) an account with equal debits and credits;
 - (c) an account with unequal debits and credits.
 7. Show by using debits and credits how an account should be balanced when the debits and credits are not equal.
 8. Describe the mechanics of taking a trial balance.
 9. Explain the methods of finding errors in a trial balance.
 10. Explain how an account which does not balance should be ruled to show the resulting balance to start the next period.
 11. Explain the various methods of correcting errors in the entries.
 12. Why is the use of an eraser or ink eradicator inadvisable?
 13. Why is it advisable to rule and balance accounts at time of taking a trial balance?

CHAPTER VI

INTERPRETATION OF THE RECORDS

FINANCIAL STATEMENTS

Basis for Preparation of Statements. The results of bookkeeping operations for a period are summarized in the accounts as listed in the trial balance. These accounts are analyzed and the essential information required by the proprietor regarding his business is prepared therefrom. This is done by making two statements, one, showing the values of the assets owned and the interests therein, called the *balance sheet*, and the other, showing the results of operating the business, called the *profit and loss statement*. These statements are commonly referred to as *financial statements*.

This chapter is concerned with the procedure of preparing these financial statements.

Statement. A statement, in accounting, refers to the presentation of facts in non-technical form, readable by a person not technically trained in accounting.

A statement may be made of the results shown by one account, or by a group of accounts, which, together, show certain facts or results. Statements are made from information contained in the accounts of a business, but are not considered a part of the bookkeeping records themselves.

Accounting Periods. At the end of a period, which may be a month, three months, six months, or a year, the records of the business are analyzed for the determination of the proprietor's capital and the result of operations for the period.

The period for which this information is determined is

called an *accounting period* of the business. If the period is a *twelve-month* period, and begins on any day other than January 1, it is called a *fiscal year*. A business may have a fiscal year beginning July 1, and ending June 30. If the period is twelve months, and begins January 1, and ends December 31, it is called a *calendar year*.

Many businesses prepare statements once a month, even though the accounting period is twelve months or a year. The year is the common accounting period in most business enterprises.

Method of Preparing Financial Statements. In explaining the preparation of financial statements, the trial balance of John Black at the end of July is used. This trial balance for convenience is repeated:

JOHN BLACK			
TRIAL BALANCE, JULY 31, 19—			
Cash	5224.20		
Atlas Manufacturing Company	400.—		
Furniture and Furnishings	500.—		
Office Appliances	320.—		
Evening Times Company		60.—	
Trade Journal, Inc.		80.—	
United Supply Company		62.50	
John Black — Capital		6000.—	
Salaries	400.—		
Traveling Expense	75.80		
Stationery and Supplies	62.50		
Advertising	140.—		
Rent	120.—		
Commission Income		1040.—	
	<u>\$7242.50</u>	<u>\$7242.50</u>	

Six-Column Working Sheet. To facilitate the analysis of the trial balance accounts for statement purposes, a sheet

of columnar paper may be used which contains the following sections:

Trial Balance
Nominal or Profit and Loss
Real or Balance Sheet

The trial balance at the close of the period is written on this working sheet and the amounts, according to their classification, are extended into either the Nominal or Real sections. The six-column working sheet using for analysis the accounts of John Black for statement purposes is illustrated below.

JOHN BLACK
SIX-COLUMN WORKING SHEET
JULY 31, 19—

	TRIAL BALANCE DEC. 31, 19—		NOMINAL ACCOUNTS		REAL ACCOUNTS	
			EXPENSE	INCOME	ASSETS	LIABILITIES AND CAPITAL
Cash	5224.20				5224.20	
Atlas Manufacturing Company	400.00				400.00	
Furniture and Furnishings	500.00				500.00	
Office Appliances	320.00				320.00	
Evening Times Company		60.00				60.00
Trade Journal, Inc.		80.00				80.00
United Supply Company		62.50				62.50
John Black, Capital		6000.00				6000.00
Salaries	400.00		400.00			
Traveling Expenses	75.80		75.80			
Stationery and Supplies	62.50		62.50			
Advertising	140.00		140.00			
Rent	120.00		120.00			
Commission Income		1040.00		1040.00		
	7242.50	7242.50				
Net Profit			241.70			241.70
			1040.00	1040.00	6444.20	6444.20

The trial balance contains all the accounts in the ledger which are open, and may be expressed in mathematical form in the following equation:

$$\text{Assets} + \text{Expenses} = \text{Liabilities} + \text{Capital}_1^* + \text{Income}$$

The five classes of accounts named in this equation are listed on the trial balance in debit and credit columns. The Assets and Expenses, which are on the left of the equality sign, show debit balances on the Ledger, and the Liabilities, Capital₁, and Income accounts, which are on the right side of the equation, have credit balances.

All the amounts in the trial balance are extended into either the Nominal or the Real sections, depending on their nature. The excess of the Income column of the Nominal section over the Expense column of this same section is the Net Profit for the period and the amount is inserted in the Expense column to make this column balance with the Income column.

The amount of the Net Profit is also inserted in the Liabilities and Capital column of the Real section, as it represents the increase in capital for the period. The total of the Liabilities and Capital column, including the Net Profit, should equal the total of the Assets column of the Real section.

The Nominal section now contains every amount which is needed for the preparation of the profit and loss statement and the Real section contains all the amounts to be used in the balance sheet. The *pro-forma* statements may now be prepared from the working sheet very readily and without further analysis.

It should be observed that the six-column working sheet is merely a medium for the analysis of the figures for statement purposes and is not in any sense a statement in itself. It is, as its name indicates, merely a "working sheet."

Balance Sheet. The real accounts, shown on the working

* Capital₁ denotes capital at the beginning of the period. Capital₂ used later, will denote capital at the end of the period.

sheet, page 83, may be arranged in statement form as follows:

FORM No. 1

JOHN BLACK

BALANCE SHEET AS AT JULY 31, 19—

ASSETS		LIABILITIES AND CAPITAL	
Cash	\$5224.20	Evening Times Company	\$60.—
Atlas Manufacturing Company	400.—	Trade Journal, Inc.	80.—
Furniture and Furnishings	500.—	United Supply Company	62.50
Office Appliances	320.—	Total Liabilities	202.50
		John Black, Capital	
		Balance, July 1	6000.—
		Net Profit	241.70
			6241.70
	\$6444.20	Total Liabilities and Capital	\$6444.20

This same balance sheet, in report form, may be arranged as follows:

FORM No. 2

JOHN BLACK

BALANCE SHEET AS AT JULY 31, 19—

ASSETS

Cash	\$5224.20
Atlas Manufacturing Company	400.—
Furniture and Furnishings	500.—
Office Appliances	320.—
Total Assets	\$6444.20

LIABILITIES AND CAPITAL

Evening Times Company	60.—
Trade Journal, Inc.	80.—
United Supply Company	62.50
Total Liabilities	202.50

John Black, Capital	
Balance, July 1	\$6000.—
Add:	
Net Profit, July 1-31	241.70
Total Liabilities and Capital	\$6241.70
	\$6444.20

Discussion of Balance Sheet. Form No. 1 is the balance sheet in account form, and Form No. 2 is the balance sheet in report form. The account form takes less space vertically than the report form. Both forms contain the same information. In the report form, the Liabilities and Capital items are arranged vertically under the Assets, no attempt being made to classify the accounts as to debit and credit balances.

The accounts on the account form are arranged according to the balances of the accounts in the Ledger, that is, the asset accounts which have debit balances are shown on the left side of the balance sheet, and the Liability and Capital accounts, which are credit balances in the Ledger, are placed on the right side of the statement.

A balance sheet is a statement of the assets, liabilities, and proprietor's capital at a *particular moment* of time. The title to the statement should be expressed so that it is evident that it is a statement at a particular time. In the title to the balance sheet illustrated in Form No. 1 and Form No. 2, the words "as at" are used to emphasize the fact that the balance sheet reflects the condition of the business on that particular date. Another method by which the title might be expressed is the following:

JOHN BLACK

BALANCE SHEET, JULY 31, 19—

While the same meaning is expressed by this title, yet the words "as at," used in the titles on Form No. 1 and Form No. 2, add emphasis to the date of the balance sheet and are not, therefore, superfluous.

Other Titles of Balance Sheet. Other titles used in referring to the statement called the balance sheet are: Statement of Assets and Liabilities; Statement of Resources and Liabilities; Statement of Condition.

Profit and Loss Statement. The items in the nominal accounts section of working sheet, on page 83, may be arranged in statement form as follows:

JOHN BLACK

PROFIT AND LOSS STATEMENT FOR THE MONTH OF JULY, 19—

Commission Income		\$1040.—
Deduct: Operating Expenses		
Salaries	\$400.—	
Traveling Expenses	75.80	
Stationery and Supplies	62.50	
Advertising	140.—	
Rent	120.—	798.30
Net Profit for the Month of July, 19—		<u>\$241.70</u>

Explanation of Profit and Loss Statement. The profit and loss statement is a summary of operations for the period. Consequently, the title of this statement should always indicate the period covered by the statement. Another heading which may be used is the following:

JOHN BLACK

PROFIT AND LOSS STATEMENT, JULY 1 TO JULY 31, 19—

Either heading is entirely satisfactory.

In preparing the profit and loss statement, the income derived from the operation of the business proper is shown in the first section of the statement. The expenses paid to produce this income, that is, the operating expenses, are deducted to obtain the net result of operations.

Other Titles of Profit and Loss Statement. Other titles used to designate the profit and loss statement are: Income and Expense Statement; Statement of Revenue and Expense; Operating Statement; Income Sheet; Profit and Loss Account; Revenue Account. All refer to the detail showing the income and expenses in some form. The Profit and

Loss Statement is the title most commonly used in service and in trading businesses.

Relationship of Balance Sheet and Profit and Loss Statement. By referring to the working sheet form on page 83, it will be noted that the result of operating is shown as the balance, in the real section and the nominal section. The net profit may be obtained by subtracting from the total assets the liabilities and the capital at the beginning of the period. This amount should agree with the net profit obtained by subtracting the expenses from the income.

The new capital balance to be used in the balance sheet is the capital at the beginning plus the net profit for the period (Capital₂).

The net profit (from the profit and loss accounts) shows the net change in the capital during the period. As the nominal accounts show increases and decreases of capital due to operations, and these accounts are separated from the real accounts, the result of these changes merged with the old capital account will give the new capital account balance. Therefore, the omission of the nominal accounts from the balance sheet group will necessarily appear in the difference between the real accounts, which will be the net profit.

If the nominal accounts were to be added into the balance sheet section, that section would balance just as the trial balance, which contains all accounts, is in balance. It is evident, therefore, that the profit and loss statement is subsidiary to the balance sheet, and merely explains in detail the net profit or loss shown in the balance sheet. (No additional investment or withdrawal by the proprietor is considered at this time.)

Relationship of Trial Balance and Statements. It should be noted that each account on the trial balance was used

on either the balance sheet or the profit and loss statement. The accounts showing debit balances were exhibited on the statements either as assets or expenses; accounts showing credit balances were exhibited in the statements as liabilities, capital, or income.

A rule for classifying the accounts on a trial balance may be stated as follows:

A debit balance on the trial balance is either:

- (a) an asset
- (b) an expense

A credit balance on the trial balance is one of the following:

- (a) a liability
- (b) capital
- (c) an income

Relationship of Trial Balance, Balance Sheet, and Profit and Loss Statement. The function of the trial balance, balance sheet, and profit and loss statement may be summarized as follows:

Trial Balance: check or proof of the clerical accuracy of the posting. A summary of the Ledger showing account titles and balances.

Balance Sheet: a statement of the assets and liabilities taken from the trial balance to determine the proprietor's capital at the end of the period.

Profit and Loss Statement: a statement of the income and expenses taken from the trial balance to determine and account for the changes in capital during the period.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. What is meant by an *accounting period*?
2. Why is the life of a business divided into periods?
3. Define a *fiscal year*; a *calendar year*. Explain the procedure of analyzing the trial balance in order to prepare statements.
4. Define *balance sheet*.
5. What are three other names given to the balance sheet?
6. From what source is the information which is used on the balance sheet obtained?
7. Describe the report form of balance sheet.
8. Describe the account form of balance sheet.
9. In what respects do these forms differ?
10. (a) Why are the words "as at" used in the title of the balance sheet?
(b) Are these words necessary?
11. In what respects do the report form and account form of the balance sheet differ?
12. How may the result of operations for the period be determined if the capital at the beginning and at the end of the period are known? Illustrate.
13. What is the content of the profit and loss statement? Define net income.
14. In the title to the profit and loss statement, the following expression is used "... for the month of July 19—." Explain the necessity for these words. How may this same idea be conveyed in other ways?
15. Explain the relationship of the profit and loss statement to the balance sheet.
16. What is the purpose of each of the following: trial balance; balance sheet; profit and loss statement?
17. What accounts always show debit balances?
18. What accounts always show credit balances?
19. Explain the difference between a statement and an account.

CHAPTER VII

CLOSING THE BOOKS

Capital Account in Ledger and Capital Account in Balance Sheet. The statements prepared in the preceding chapter from the books of John Black show the condition of his business as at July 31, 19—, and the result of operating during the period.

As these statements were prepared from the trial balance (independent of the Ledger), no change has been made in the accounts as shown in the Ledger of John Black. The statements have been accepted by Mr. Black as correct, and the Ledger accounts should be made to agree with them, before recording any items pertaining to the next accounting period in the Ledger.

The Ledger account of the proprietor, John Black, has, according to the trial balance, a credit balance of \$6,000. This account is intended to show his interest in the business. But, according to the balance sheet, John Black's capital at July 31, 19— is \$6,241.70; this exceeds the amount in the Ledger account by \$241.70, which is the net profit for the period.

The difference between the Income and Expense accounts is, according to the profit and loss statement, also \$241.70. In other words, the difference between the Income and Expense accounts in the Ledger is the net profit for the period, or the net increase of the capital.

The gains from operating the business belong to the proprietor, and the net profit should, at the end of the period, be transferred to his account, so that the proprietor's Ledger account will agree with the capital as shown by the balance sheet.

JULY 31, 19—

3	Commission Income		1040	—		
2	Profit and Loss				1040	—
	To transfer the income earned from Commission Income to Profit and Loss					

The balances of the Operating Expense accounts are next transferred to Profit and Loss account. These accounts, before closing, appear in the Ledger as follows:

[illegible][illegible]

19— July	6	J	1	62 50						
-------------	---	---	---	-------	--	--	--	--	--	--

[illegible][illegible]

The balances of these accounts may be transferred to the Profit and Loss account by means of the following entry (No. 2), made in the Journal and posted to the Ledger:

JULY 31

2	Profit and Loss	798	30		
2	Salaries			400	—
3	Traveling Expense			75	80
3	Stationery and Supplies			62	50
3	Advertising			140	—
3	Rent			120	—
	To transfer the balances of the operating expense accounts to Profit and Loss account				

After posting this entry, the Expense accounts are balanced and ruled as shown on pages 97-98 of the Model Ledger.

The Profit and Loss account now appears as follows:

PROFIT AND LOSS

19—													
July	31		J	4	798	30	July	31		J	4	1040	—

The balance of this account is the net profit for the period. This net profit is then transferred from the Profit and Loss account to the Proprietor's account through the following entry (No. 3), made in the Journal and posted to the Ledger.

JULY 31

2	Profit and Loss	241	70		
2	John Black, Capital			241	70
	To transfer the Net Profit for the period from Profit and Loss to John Black, Capital				

After posting this entry, the Profit and Loss account is balanced and ruled as illustrated on page 97.

On pages 96 to 98, the Ledger of John Black is illustrated after closing. It should be noted that, after closing, only the Asset, Liability, and Capital accounts are open in the Ledger, and that John Black's Capital account now agrees with the difference between these Asset and Liability accounts, as shown in the balance sheets on page 85 of Chapter VI.

Proof Trial Balance. After closing the Ledger, a trial balance should be taken of the accounts open in the Ledger. A trial balance taken after closing the Ledger is called a *proof trial balance*, *final trial balance*, *post-closing trial balance*, *after closing trial balance*.

JOHN BLACK

TRIAL BALANCE AFTER CLOSING, JULY 31, 19—

Cash	\$5224.20	
Atlas Manufacturing Company	400.—	
Furniture and Furnishings	500.—	
Office Appliances	320.—	
Evening Times Company		60.—
Trade Journal, Inc.		80.—
United Supply Company		62.50
John Black, Capital		6241.70
	<u>\$6444.20</u>	<u>\$6444.20</u>

This final trial balance is in agreement with the balance sheet.

CLOSING THE BOOKS

MODEL LEDGER, PAGE 1

CASH

19— July	1	J 1	6000	—	19— July	2	J 1	120	—
	12 6640	J 2	300	—		3	J 1	500	—
	18 1415.80	J 2	100	—		8	J 2	100	—
	30 5224.20	J 3	240	—		15	J 2	100	—
						22	J 3	100	—
						25	J 3	320	—
						29	J 3	100	—
						31	J 3	75 80	—
ATLAS MANUFACTURING COMPANY									
19— July	26	J 3	400	—					
MECCA MANUFACTURING COMPANY									
19— July	22	J 2	240	—	19— July	30	J 2	240	—
FURNITURE AND FURNISHINGS									
19— July	3	J 1	500	—					
OFFICE APPLIANCES									
19— July	5	J 1	320	—					
TIMES COMPANY									
					19— July	10	J 2	60	—

97

TRADE JOURNAL, INC.

[illegible]

Nominal Accounts as Temporary Proprietorship Accounts.

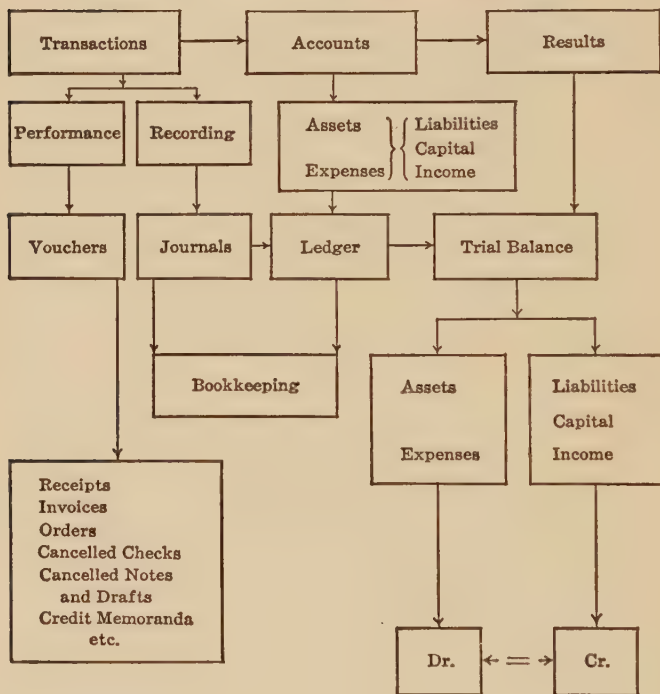
The expense and income accounts, inasmuch as they are closed into the proprietor's account at the close of the period, are called *temporary proprietorship accounts*. During a business period, the increases of proprietary interest are recorded temporarily in the income and expense accounts. At the close of the period, the net increase or net decrease of capital, as reflected by the difference between the income and expense, is transferred to the proprietor's account. The principal function of the income and expense accounts is to furnish information as to the causes of the increase or decrease of capital. Having performed this function, they are merged with the capital since the information they have furnished does not apply to any other period. In each succeeding period the same cycle of operations is performed.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What is meant by closing the Ledger?
2. Why is the Ledger closed?
3. What accounts are affected in closing the Ledger?
4. Define the Profit and Loss account.
5. Outline step by step the process of closing the Ledger, giving the purpose of each step.
6. What is a proof trial balance?
7. The Nominal accounts are sometimes called Temporary Proprietorship accounts. Explain.
8. What classes of accounts appear in the proof trial balance?

9. How are the closing entries determined?
10. Why is a Profit and Loss account opened?
11. Explain the relation of the Nominal accounts to the Balance Sheet accounts, as indicated in the closing of the Ledger.

CHART OF BOOKKEEPING OPERATIONS



CHAPTER VIII

ACCOUNTING FOR A TRADING BUSINESS

Trading Business. A business which buys and sells goods is called a *trading business*. The goods which are bought and sold are called *merchandise*, irrespective of their nature. Thus, the coal and wood in a coal and wood business, the meat and groceries in a provision store, and the almost innumerable types of goods in a department store are all called merchandise.

The service performed by a trading business in connection with the merchandise is merely the turnover of the goods. The merchandise is sold in the identical condition in which purchased; no expenditure being made upon the merchandise itself to make it marketable.

Source of Income of Trading Business. The merchandise in a trading business is purchased at one price and sold at a higher price. The principal source of income in a trading business is, therefore, the profit on the merchandise which is sold.

The selling price of merchandise is made up of two parts; namely, the amount of the cost of the goods and the profit realized on the sale. This profit (the difference between the selling price and the cost price) is known as the *gross profit*. The gross profit in a trading business corresponds to the commission income in a service business or one in which goods are sold for some one else on a commission.

Accounting for Gross Profit in a Trading Business. To determine the gross profit of a business during a period, the following elements should be known:

1. Invoice cost of goods purchased.
2. Amount paid for freight, express, or cartage on the goods to get them to the place of business ready for sale.

3. The amount of goods purchased which are returned or the allowances made thereon for any reason.
4. The value of the goods remaining unsold.
5. The amount received for goods sold.
6. The amount of goods sold which are returned or allowances made thereon.

To obtain this information regarding the merchandise, the following accounts may be kept:

1. Purchases of Merchandise, or simply Purchases.
2. Freight, Express and Cartage In, or Freight In.
3. Purchases Returns and Allowances.
4. Merchandise Inventory.
5. Sales of Merchandise, or merely Sales.
6. Sales Returns and Allowances.

EXPLANATION OF MERCHANDISE ACCOUNTS

Purchases. This account is used to record the purchase or *cost* price of all the merchandise bought. At the time of the purchase the cost of goods is debited to this account. The Purchase of Merchandise account is classified in the expense group.

Freight, Express and Cartage In. This account is used to record the transportation charges paid to get the merchandise into the store ready for sale. These charges are *an addition* to the invoice *cost* of the *goods purchased* and are debited to this account. Freight, Express and Cartage In is classified as an expense account. At closing, this account is closed into Purchases. (See entry (3), page 137.)

Purchases Returns and Allowances. This account is used to record the value of purchases which are actually returned and the amount of allowances made on purchases because of defects, breakage, etc. The value of goods returned and

the amount of the allowances are credited to this account. Purchases Returns and Allowances is classified as an income account. At the end of the accounting period this account is closed into Purchases. (See entry (4), page 137.)

Merchandise Inventory. This account is used to record the value of the goods on hand at the end of a period. The value of the goods remaining unsold at the end of the period is debited to this account. The value of Merchandise Inventory is obtained by actual count of the goods and the value calculated at cost price, or cost or market, whichever is lower. The Merchandise Inventory account is classified as an asset account. (See Inventory explanation on pages 138-39.)

Sales. This account is used to record the selling price of all the goods sold. The amount of each sale is credited to this account. The Sales of Merchandise account is classified as an income account. (See closing entries and model exercise for closing, Chapter IX.)

As stated previously, each sale of merchandise is made up of two parts; namely, the cost of the goods sold and the profit on the sale. Due to the impracticability in most types of business of dividing each sale into these two parts, the entire *selling price* is considered *during the accounting period* as income, and the entire purchase price is considered as expense. At the end of the period, the value of the goods on hand is determined and subtracted from the total purchases to obtain the cost of the goods actually sold. In other words, during the accounting period, the asset element in merchandise is ignored, and is considered only at the end of the accounting period. Entries are made at closing, (1) to transfer the Inventory of Merchandise from Purchases (an expense account) to the Inventory (an asset

account); (2) to close the cost of sales to the Sales account. (See entries (1), page 133, and (5), page 137, in Chapter IX.)

Sales Returns and Allowances. This account is used to record the value of goods sold which have been returned by customers of the business and the amount of allowances which are made on sales because of defects, breakage, etc. This account is debited for the selling price of the goods returned and allowances made on sales. The Sales Returns and Allowances account is classified as an expense account. At the end of the accounting period, it is closed into the Sales account. (See entry (2), page 137.)

Gross Profit. The information furnished by these accounts is used in obtaining the gross profit in the following manner:

Gross Sales	\$.....	
(obtained from the account)		
Less: Sales Returns and Allowances		
(obtained from the account)		
Net Sales		\$.....
(obtained by subtraction)		
Deduct: Cost of Goods Sold:		
Gross Purchases	\$.....	
(obtained from the account)		
Add: Freight, Express and		
Cartage In		
(obtained from the account)		
Total Cost of Purchases		
(obtained by addition)		
Less: Purchases Returns and		
Allowances		
(obtained from the account)		
Net Cost of Purchases		
(obtained by subtraction)		
Less: Merchandise Inventory		
(obtained from physical inventory)		
Gross Profit		\$.....
(obtained by subtraction of Cost of Goods Sold from Net Sales)		

Note: If there is an inventory at the beginning of the period, it is shown under Cost of Goods Sold and added to Purchases.

COMPARISON OF ACCOUNTS OF COMMISSION BUSINESS
vs. TRADING BUSINESS

Real Accounts. The addition of Merchandise Inventory to the asset group is the only change in the real accounts.

Nominal Accounts. The following form shows the nominal accounts of a trading business as compared to those of a service business:

NOMINAL ACCOUNTS SERVICE BUSINESS		NOMINAL ACCOUNTS TRADING BUSINESS	
EXPENSE	INCOME	EXPENSE	INCOME
	Commission In- come	Sales Returns and Allowances (Merchandise In- ventory No. 1) Purchases Freight In	Sales Purchases Re- turns and Allowances (Merchandise Inventory No. 2)
Salaries Rent Office Supplies Telephone and Telegrams Advertising Travel Expense Miscellaneous Expense		Salaries Rent Office Supplies Telephone and Telegrams Advertising Travel Expense Sundry Expense	
		Discount on Sales	Discount on Purchases

By comparison with the chart of accounts for a commis-
sion business (page 34), the expansion of the Nominal
Accounts section of the chart of a trading business above is
noticeable.

The gross profit in the commission business is obtained
from one account, or the addition of two or more divisions

of income. In a trading business, the addition and subtraction of several expense and income accounts is necessary to obtain this gross profit. The addition of non-operating expense and income accounts is also noted.

SUPPLEMENTARY ACCOUNTING RECORDS

Business Forms Used in a Trading Business. Written memoranda are needed in business to record necessary information concerning transactions, and to guard against errors and misunderstandings.

The following are some common forms used in trading businesses:

- Receipt
- Sales Order
- Purchase Order
- Purchase Invoice
- Debit Memorandum
- Sales Invoice
- Credit Memorandum
- Monthly Statement

Vouchers — Receipts. The term *voucher* refers to a memorandum that contains information which furnishes proof of certain operations performed by the parties to a contract. Vouchers support and furnish proof of the entries in the Journals and Ledgers. The most common vouchers in any business are receipts, orders, and invoices.

A receipt is a written acknowledgment that money or goods or other assets have been received.

A form of a receipt is shown below.

No.....	193..
Received of.....	
	\$.....
For.....	
	 Signature

An invoice or statement may be receipted by having written or stamped across its face the following or its equivalent:

Received Payment
January 26, 193..
Brown Drug Company
By.....

Orders. Orders represent the acceptance by the buyer of the offers of sale made by the seller. Orders may be received orally, by telephone, or by written letter or order from the buyer. If received orally or by telephone, the order is immediately written down by the salesperson receiving it on a sales order blank. The written signature of the buyer should be secured where possible.

Sales Order. This name is given to the order given by a customer for merchandise, and is usually made out by an agent of the selling company. Specially designed sales forms are used by most firms.

Purchase Order. This name is given to the order for merchandise purchased, which is made out by the buying company on its own printed form. An ordinary letter from the buying company to the selling company serves as a purchase order and is a sales order to the selling company.

It is important that these orders should be kept on file. In case of disputes they are useful in verifying the accuracy of the contentions of either party, and in definitely placing the blame for errors.

Order forms vary in size and content, according to the type of business. The essential points in the order are the specifications as to the goods desired and the signature of the buyer. In some cases elaborate contracts are drawn up and signed by each party.

A printed form is convenient for filing purposes because of its uniform size.

Purchase Invoice. An invoice is a statement showing:

1. The names of the buyer and the seller, addresses of each, and the relation of one to the other.
2. The items of merchandise sold by the seller, with prices of each item and total value of the merchandise sold.
3. The date of the sale and the terms of payment.
4. How and when shipped, to whom shipped and any other helpful information.

A form of a purchase invoice is shown on page 110. A form of purchase order is shown on page 109. A purchase order is made out by the purchaser and is a sales order to the seller. The seller frequently uses a sales invoice as a sales order.

Form of Purchase Order.

PURCHASE ORDER

Order No.....

Requisition No.....

J. D. SMITH COMPANY

TOWNSEND, MASS.

Date..... 19....

To.....

Address.....

.....

Please supply and deliver to the above address the items listed below:

To be shipped.....

By.....

J. D. Smith Company

(Please acknowledge this order by number and state when delivery will be made.)

By.....

Form of Invoice.

Bill No.....			
Your Order No.....		Boston, Mass., Dec. 9, 19....	
JOHN SMITH & Co. 267 Main Street			
Sold to.....FRANK J. STRATTON.....Dedham, Mass.....			
Shipped via.....		To.....	
Terms: 2/10; net /30			

	500	lbs. Sugar	.04 $\frac{3}{4}$	23	75		
	1	case Peas (6 doz.)	2.00	12	00		35 75

Purposes of the Invoice. The invoice serves as an original document and presents evidence of facts to be recorded. It supplements and supports the Journal record, giving details such as terms of the contract of sale or purchase, description of goods, price per unit, etc.

The form of a purchase invoice and a sales invoice are the same. A purchase invoice to the buyer is the sales invoice from the seller. An invoice is frequently called a *bill*.

Bills, or invoices, and orders are usually prepared in duplicate or triplicate, so that each party concerned has identical records of the transaction. The familiar "sales slip" of the department store, in purchases on credit, is an invoice.

Monthly Statement. It is customary in all businesses to render a statement monthly, which operates as a reminder to the customer and serves as a check on the accuracy of his

account on the books. The statement may be an abstract of the Ledger account, or may be in detail, thereby serving as an itemized bill for the month's purchases. The first method is common among wholesalers who sell to retail stores. The second method is prevalent with retail stores, since it saves labor and greatly reduces the number of requests for duplicate bills. Most customers of retail stores do not keep books and frequently mislay their invoices which are received with the goods.

MONTHLY STATEMENT
(ABSTRACT OF ACCOUNT)

<i>Monthly Statement</i>							
Boston, Mass., Nov. 1, 19...							
JONES-MARSTERS COMPANY							
250 Washington Street							
Sold to....Smith-Wright Company....							
....Wakefield,Mass.							
Oct.	2	To mdse.	250	00	346	60	
	10	To mdse.	24	60			
	18	To mdse.	72	00			
Cr.							
	8	By cash	100	00	120	00	
	15	By return	20	00			
Balance Due					226	60	

MONTHLY STATEMENT
(ITEMIZED)

Dept. & Sales No.	Date	Articles	Charges	Credits	Daily Balance Pay last amt. in this column
	Nov.	Balance forward per account rendered			80.31
	1	Cash *		41.31	39.00
2520	16	Shoes	8.50		47.50
716	20	Ties	8.50		56.00
2415	21	Cottage Sets	3.00		
3411		Scarf	1.98		
		Covers	15.96		76.94
2613	27	Dress	5.95		
3710		Shade	3.75		
3150		Dress	12.45		99.09
	30	Cash *		39.00	
3411	27	Covers *		15.96	44.13

* Credit items frequently are entered in red ink. The above bill is as made out on a billing machine or typewriter.

Debit Memorandum; Credit Memorandum. When goods are returned to a seller by the buyer because of an error in shipping wrong goods, or because the quality is not satisfactory, or for any other reason, the buyer requests and expects credit for the invoice value of the goods. He sends a debit memorandum to the seller or the seller sends him a credit memorandum on receipt of the goods.

The words debit and credit indicate the entry by the bookkeeper. If a debit memorandum is made out, the bookkeeper debits the person or firm's account. If a credit memorandum is made out, the bookkeeper credits the customer's account.

When the bookkeeper receives a debit or credit memorandum from another business enterprise he makes an entry on his books in reverse order. That is, he credits the firm that sends the debit memorandum and debits the firm that sends him a credit memorandum.

The form of the credit memorandum or debit memorandum is practically the same as a bill or invoice except that the words debit or credit memorandum are printed on the face of the form.

DISCOUNTS BASED ON PURCHASES AND SALES

Classes of Discounts. The discounts or deductions based on purchases and sales of merchandise may be classified as follows:

1. Trade discounts
2. Cash or merchandise discounts

Trade Discounts. A trade discount is a deduction allowed from the list or catalogue prices of merchandise for any reason other than to induce payment within a specified time.

Some of the common reasons for allowing trade discounts are:

1. To adjust list or catalogue prices to the prevailing market prices.
2. For purchases in large quantities, called jobbers' or wholesalers' discounts.
3. To secure the trade of a desired customer.

Obviously, discounts allowed for the above reasons are merely reductions from the list or catalogue prices made to obtain the *actual* selling price of the merchandise. Consequently, the merchandise should be recorded on the books of the vendor at the actual selling price, that is, the list price less the trade discount, and on the books of the buyer at the actual cost to him. There is, therefore, no account kept on the books of a business with trade discounts on merchandise.

Cash Discounts. A discount allowed from the invoice price of merchandise for payment within a specified time is called a cash discount. A discount, to be classified as a cash discount, must be absolutely contingent upon payment within the period specified.

Cash discounts are classified as:

1. Discounts on sales
2. Discounts on purchases

A *discount on sales* is an allowance made by a business to a customer for payment within the specified time.

A *discount on purchases* is an allowance made to a business by the vendor for payment within the specified time.

Terms of Invoices. The terms of payment are usually indicated on the face of the invoice and are expressed in the following manner:

Cash or net cash means that the bill is payable immediately (time varies from 5 to 30 days) and that no discount is allowed.

Cash 2% means that the bill is payable immediately upon receipt of the goods and that 2% discount is allowed.

Net 30 days or n/30 means that the bill is payable in thirty days and no discount is allowed.

2% 10 days, net 30 days, abbreviated to 2/10, n/30, means that the bill is due in 30 days, but if it is paid within 10 days a discount of 2% will be allowed.

3% 10 days, 2% 30 days, net 60 days, abbreviated to 3/10, 2/30, n/60, means that the bill is due in 60 days, but if it is paid within 10 days a discount of 3% will be allowed or if paid in 30 days a discount of 2% will be allowed.

Note 30 days means that a note for the full amount of the bill, payable in 30 days, is to be given.

C.O.D. American Express means that the goods have been shipped by the American Express, cash to be paid on delivery.

C.I.F. means that the seller pays cartage, insurance, and freight.

F.O.B. relates to delivery of goods; it means *free on board*, or delivered properly crated or wrapped for transportation at the railway station designated.

E.O.M. means *end of month* and indicates that the discount period begins on the last day of the month. Thus 2/10 e.o.m. means that a discount of 2 per cent will be allowed if the bill is paid ten days after the end of the month in which the transaction took place.

Significance of Discounts on Sales. A business which sells its goods on the terms 2/10, n/30, says by implied statement to its customers, "This bill is due in 30 days, but if you will pay this bill on or before the 10th day, in other words, 20 days before it is due, we will pay you for

the use of your money, 2 per cent of the amount of the invoice." A cash discount allowed customers is nothing more than money paid for the use of money; that is, interest. For this reason, cash discounts on sales are usually classified as an expense of financing the business; that is, a financial expense.

Discount on Sales Account. This account is debited for all cash discounts allowed on sales to customers. The Discount on Sales account is classified as a non-operating, financial expense account.

Significance of Discounts on Purchases. A business which buys goods on the terms 3/5, n/30, has the option of paying for them in 30 days or paying for them in 5 days. If the business pays for the goods on the 5th day; that is, twenty-five days before payment is due, it is allowed 3 per cent discount on the face of the invoice. In other words, if the business has capital enough to pay the invoice in 5 days, it receives 3 per cent of the face of the invoice for the use of this money twenty-five days before it is due. The discount received is, therefore, merely interest paid for the use of the money for twenty-five days. The income earned is a financial income, inasmuch as it is due to the use of the capital.

Discount on Purchases Account. The account used to record cash discounts allowed on accounts payable is called *Discount on Purchases*. This account is credited for all cash discounts allowed to the business on purchases. The Discount on Purchases account is classified as a non-operating, financial income account.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. Define a trading business.
2. Explain the essential points of difference between a service and a trading business.
3. What are the elements which must be known in order to determine the gross income?
4. Name and explain the accounts which may be kept to record these elements.
5. Show by a form the arrangement of the accounts named in Question 4 in order to reflect the gross profit in a trading business.
6. Explain the importance of orders, invoices, statements, and credit memoranda in a trading business.
7. Define a voucher; receipt; order; invoice.
8. Why are specially designed forms of advantage to a business?
9. Name the essential information contained in an invoice or bill of goods.
10. What is the significance of terms 2/10, n/30, f.o.b. shipping point?
11. What two kinds of monthly statements are used in business?
12. Explain the difference in accounting treatment of trade discounts and cash discounts.
13. Explain the significance of cash discounts on sales.
14. Explain the significance of cash discounts on purchases.
15. Explain how the gross profit in a commission business is obtained.
16. Explain how the gross profit in a trading business is obtained.

CHAPTER IX

MODEL ILLUSTRATIVE EXERCISE — TRADING BUSINESS

THE following illustrative exercise is intended to show the accounts and bookkeeping procedure of a trading business, using one Journal and Ledger. The following are shown:

1. Chart of Accounts
2. List of Transactions
3. Journal Record of Transactions
4. Accounts in Ledger (posting all completed)
5. Trial Balance
6. Analysis for Statements
7. Balance Sheet
8. Profit and Loss Statement
9. Closing Entries

These models may be followed in doing the laboratory exercises.

Mixed Accounts. Certain accounts change, due to fluctuations in value which result from many causes, and other accounts, because of the method of recording transactions in the books, at the end of an accounting period, are partly real and partly nominal. Merchandise Inventory, Purchases and Sales accounts are mixed accounts in the following chart.

In determining the classification of any account in making a chart, the use of the account in the statements is the deciding factor. The element which predominates at the time the statements are made determines the class in which the account is classified. If the expense is larger than the

May, 19—

- coverings. He invests in the business cash, \$20,000.
1. He rents a store at 80 Port Street, City, and agrees to pay on the 15th of each month a rental of \$120.
 1. Buys furniture and furnishings from White Company for \$1,200. Terms, net cash.
 3. Buys merchandise from A. K. Klein Co. for \$6,000. Terms, 3/5, n/30.
 5. Buys merchandise from Lore Manufacturing Co. for \$4,000. Terms, 2/10, n/30.
 6. Sells merchandise, \$1,820, to Otis Bros. Terms, 2/10, n/30.
 8. Sells merchandise, \$960.40, to E. T. Sadler. Terms, 2/10, n/30.
 8. Pays cash, \$5,820, to A. K. Klein Co. in full for goods purchased on the 3rd, less the discount of \$180.
 10. Pays cash, \$112.60, for advertising.
 12. Sells merchandise to A. R. Dorn for \$1,280.60. Terms, 2/10, n/30.
 12. Pays cash, \$1,200, to White Company in full of account.
 13. Sells merchandise to G. R. Selden for \$360. Terms, 2/10, n/30.
 13. Buys merchandise from D. A. Nason for \$2,180. Terms, 2/5, n/30.
 15. Pays cash, \$120, for rent for May.
 15. Pays cash, \$3,920, to Lore Manufacturing Co. in full for purchase of May 5th, less discount, \$80.
 16. Sells merchandise for cash, \$210.
 16. Pays cash, \$130, for salaries of employees for two weeks.

May, 19—

16. Receives cash, \$1,783.60, from Otis Bros. in full for goods sold on the 6th, less discount of \$36.40.
18. Sells merchandise to A. S. Simms for \$780. Terms, n/30.
18. Pays cash, \$2,136.40, to D. A. Nason in payment for purchase of the 13th, less a discount of \$43.60.
18. Receives cash, \$941.19, from E. T. Sadler in full payment for goods sold on the 8th, less a discount of \$19.21.
20. Purchases typewriters and adding machine from White Company for \$660. Terms, n/30.
22. Purchases merchandise from A. S. Lane for \$1,600.50. Terms, 3/10, n/30.
22. Receives cash, \$1,254.99, from A. R. Dorn in full payment for the sale of the 12th, less the discount of \$25.61.
23. Sells merchandise to N. O. Kane for \$1,310. Terms, 2/10, n/30.
23. Pays cash, \$8.30, for cleaning and sweeping.
23. Receives cash, \$352.80, from G. R. Selden in payment for the sale of May 13th, less discount of \$7.20.
24. Sells merchandise to A. R. Dorn for \$700. Terms, 2/10, n/30.
24. Purchases merchandise from Lore Manufacturing Co. for \$960. Terms, 2/10, n/30.
26. A. R. Dorn returns merchandise billed to him at \$160.
27. Returns goods to A. S. Lane from purchase of May 22nd billed to us at \$400.
27. Sells merchandise to Otis Bros. for \$460. Terms, 2/10, n/30.

May, 19—

29. Purchases merchandise from A. K. Klein Co. for \$920. Terms, 3/5, n/30.
31. An allowance of \$60 is made to Otis Bros. for defective goods in the sale of May 27th.
31. Buys merchandise for cash, \$240.
31. Pays cash, \$12.60, for telephone installation.
31. Pays cash, \$130, for salaries of employees for two weeks.
31. A. K. Klein Co. makes us an allowance of \$120 for defective goods in the purchase of May 29th.
31. Pays cash, \$220, for traveling expenses.
31. Pays cash, \$146, for freight and express bill.

MODEL JOURNAL, No. 2

MAY 1, 19—

1

	Albert E. Treen this day begins business on his own account, dealing in carpets, rugs, and floor coverings. He rents a store at 80 Port Street at a monthly rental of \$120, payable on the 15th of the month.				
1	Cash	20000	00		
3	Albert E. Treen, Capital To record the investment of Albert E. Treen. -1-			20000	00
2	Furniture and Furnishings	1200	00		
2	White Company Terms, net cash. -3-			1200	00
3	Purchases	6000	00		
2	A. K. Klein Co. Terms, 3/5, n/30. -5-			6000	00
3	Purchases	4000	00		
2	Lore Manufacturing Co. Terms, 2/10, n/30.			4000	00

MAY 6, 19—

2

1	Otis Bros.	1820	00		
5	Sales			1820	00
	Terms, 2/10, n/30.				
	-8-				
1	E. T. Sadler	960	40		
5	Sales			960	40
	Terms, 2/10, n/30.				
	-8-				
2	A. K. Klein Co.	6000	00		
1	Cash			5820	00
5	Discount on Purchases			180	00
	In payment for invoice of				
	5/3/19—, less 3%.				
	-10-				
4	Advertising	112	60		
1	Cash			112	60
	Advertising in paper.				
	-12-				
1	A. R. Dorn	1280	60		
5	Sales			1280	60
	Terms, 2/10, n/30.				
	-12-				
2	White Company	1200	00		
1	Cash			1200	00
	In full of account.				
	-13-				
1	G. R. Selden	360	00		
5	Sales			360	00
	Terms, 2/10, n/30.				
	-13-				
3	Purchases	2180	00		
3	D. A. Nason			2180	00
	Terms, 2/5, n/30.				
	-15-				
4	Rent	120	00		
1	Cash			120	00
	For month of May.				
	-15-				
2	Lore Manufacturing Co.	4000	00		
1	Cash			3920	00
5	Discount on Purchases			80	00
	In payment for invoice of				
	5/5/19—, less 2%.				

MAY 16, 19—

3

1	Cash	210	00		
5	Sales			210	00
	Cash sale.				
	-16-				
4	Salaries	130	00		
1	Cash			130	00
	Salaries for two weeks.				
	-16-				
1	Cash	1783	60		
4	Discount on Sales	36	40		
1	Otis Bros.			1820	00
	In payment for sale of 5/6/19—,				
	less 2%.				
	-18-				
2	A. S. Simms	780	00		
5	Sales			780	00
	Terms, n/30.				
	-18-				
3	D. A. Nason	2180	00		
1	Cash			2136	40
5	Discount on Purchases			43	60
	In payment for invoice of				
	5/13/19—, less 2%.				
	-18-				
1	Cash	941	19		
4	Discount on Sales	19	21		
	E. T. Sadler			960	40
	In payment for sale of 5/8/19—,				
	less 2%.				
	-20-				
2	Office Appliances	660	00		
2	White Company			660	00
	Typewriters and adding machine;				
	terms, n/30.				
	-22-				
3	Purchases	1600	50		
3	A. S. Lane			1600	50
	Terms, 3/10, n/30.				

MAY 22, 19—

4

1	Cash	1254 99		
4	Discount on Sales	25 61		
1	A. R. Dorn		1280 60	
	In full payment of sale of 5/12/19—, less 2%.			
	-23—			
2	N. O. Kane	1310 00		
5	Sales		1310 00	
	Terms, 2/10, n/30.			
	-23—			
4	Sundry Expense	8 30		
1	Cash		8 30	
	For cleaning and sweeping.			
	-23—			
1	Cash	352 80		
4	Discount on Sales	7 20		
1	G. R. Selden		360 00	
	In payment for sale of 5/13/19—, less 2%.			
	-24—			
1	A. R. Dorn	700 00		
5	Sales		700 00	
	Terms, 2/10, n/30.			
	-24—			
3	Purchases	960 00		
2	Lore Manufacturing Co.		960 00	
	Terms, 2/10, n/30.			
	-26—			
5	Sales Returns and Allowances	160 00		
1	A. R. Dorn		160 00	
	Returns on goods sold 5/24/19—.			
	-27—			
3	A. S. Lane	400 00		
3	Purchase Returns and Allowances		400 00	
	Returned goods purchase 5/22/19—.			
	-27—			
1	Otis Bros.	460 00		
5	Sales		460 00	
	Terms, 2/10, n/30.			

MAY 29, 19—

5

3	Purchases	920 00		
2	A. K. Klein Co.		920 00	
	Terms, 3/5, n/30.			
	-31-			
5	Sales Returns and Allowances	60 00		
1	Otis Bros.		60 00	
	Allowance for defective goods in			
	sale of 5/27/19—.			
	-31-			
3	Purchases	240 00		
1	Cash		240 00	
	Cash purchase.			
	-31-			
4	Telephone and Telegraph	12 60		
1	Cash		12 60	
	For installation.			
	-31-			
4	Salaries	130 00		
1	Cash		130 00	
	Salaries for two weeks.			
	-31-			
2	A. K. Klein Co.	120 00		
3	Purchase Returns and Allowances		120 00	
	Allowance for defective goods in			
	purchase of 5/29/19—.			
	-31-			
4	Traveling Expense	220 00		
1	Cash		220 00	
	Expense for month.			
	-31-			
4	Freight, Express and Cartage In	146 00		
1	Cash		146 00	
	Paid freight and express bills for			
	month.			

MODEL LEDGER No. 2, PAGE 1

CASH

19— May	1	J 1	20000 00	19— May	8	J 2	5820 00
	16	J 3	210 00		10	J 2	112 60
	16	J 3	1783 60		12	J 2	1200 00
	18	J 3	941 19		15	J 2	120 00
	22	J 4	1254 99		15	J 2	3920 00
	23	J 4	352 80		16	J 3	130 00
	31		Balance, 10346.68		18	J 3	2136 40
					23	J 4	8 30
					31	J 5	240 00
					31	J 5	12 60
					31	J 5	130 00
					31	J 5	220 00
					31	J 5	146 00
OTIS BROS.							
19— May	6	J 2	1820 00	19— May	16	J 3	1820 00
	27	J 4	460 00		31	J 5	60 00
E. T. SADLER							
19— May	8	J 2	960 40	19— May	18	J 3	960 40
A. R. DORN							
19— May	12	J 2	1280 60	19— May	22	J 4	1280 60
	24	J 4	700 00		26	J 4	160 00
G. R. SELDEN							
19— May	13	J 2	360 00	19— May	23	J 4	360 00

MODEL LEDGER, No. 2, PAGE 2

N. O. KANE

19— May 23	J 4	1310 00							
			A. S. SIMMS						
19— May 18	J 3	780 00							
			MERCHANDISE INVENTORY						
19—									
			FURNITURE AND FURNISHINGS						
19— May 1	J 1	1200 00							
			OFFICE APPLIANCES						
19— May 20	J 3	660 00							
			A. K. KLEIN COMPANY						
19— May 8	J 2	6000 00	19— May 3	J 1	6000 00				
	J 5	120 00		J 5	920 00				
	31			31					
			WHITE COMPANY						
19— May 12	J 2	1200 00	19— May 1	J 1	1200 00				
				J 3	660 00				
				20					
			LORE MANUFACTURING COMPANY						
19— May 15	J 2	4000 00	19— May 5	J 1	4000 00				
				J 4	960 00				
				24					

MODEL LEDGER, No. 2, PAGE 3

D. A. NASON

19— May 18	J 3	2180 00	19— May 13	J 2	2180 00
		A. S. LANE			
19— May 27	J 4	400 00	19— May 22	J 3	1600 50
		ALBERT E. TREEN, CAPITAL			
			19— May 1	J 1	20000 00
		PROFIT AND LOSS			
		PURCHASES			
19— May 3	J 1	6000 00			
5	J 1	4000 00			
13	J 2	2180 00			
22	J 3	1600 50			
24	J 4	960 00			
29	J 5	920 00			
31	J 5	240 00			
		PURCHASE RETURNS AND ALLOWANCES			
			19— May 27	J 4	400 00
			31	J 5	120 00
		FREIGHT, EXPRESS AND CARTAGE IN			
19— May 31	J 5	146 00			

MODEL LEDGER, No. 2, PAGE 4

SALARIES

19— May	16 31	J 3 J 5	130 00 130 00						
RENT									
19— May	15	J 2	120 —						
ADVERTISING									
19— May	10	J 2	112 60						
TELEPHONE AND TELEGRAPH									
19— May	31	J 5	12 60						
TRAVELING EXPENSE									
19— May	31	J 5	220 —						
SUNDRY EXPENSE									
19— May	23	J 4	8 30						
DISCOUNT ON SALES									
19— May	16	J 3	36 40						
	18	J 3	19 21						
	22	J 4	25 61						
	23	J 4	7 20						

MODEL LEDGER, No. 2, PAGE 5

SALES

					19— May	6		J 2	1820	—
						8		J 2	960	40
						12		J 2	1280	60
						13		J 2	360	—
						16		J 3	210	—
						18		J 3	780	—
						23		J 4	1310	—
						24		J 4	700	—
						27		J 4	460	—
SALES RETURNS AND ALLOWANCES										
	19— May	26		J 4	160	—				
				J 5	60	—				
DISCOUNT ON PURCHASES										
	19— May					8		J 2	180	—
						15		J 2	80	—
						18		J 3	43	60

ALBERT E. TREEN

TRIAL BALANCE, MAY 31, 19—

1	Cash	10,346	68		
1	Otis Bros.	400	00		
1	A. R. Dorn	540	00		
2	N. O. Kane	1,310	00		
2	A. S. Simms	780	00		
2	Furniture and Furnishings	1,200	00		
2	Office Appliances	660	00		
2	A. K. Klein Co.			800	00
2	White Company			660	00
2	Lore Mfg. Co.			960	00
3	A. S. Lane			1,200	50
3	Albert E. Treen, Cap.			20,000	00
3	Purchases	15,900	50		
3	Purchase Returns and Allowances			520	00
3	Freight, Express and Cartage In	146	00		
4	Salaries	260	00		
4	Rent	120	00		
4	Advertising	112	60		
4	Telephone and Telegraph	12	60		
4	Traveling Expense	220	00		
4	Sundry Expense	8	30		
4	Discount on Sales	88	42		
5	Sales			7,881	00
5	Sales Returns and Allowances	220	00		
5	Discount on Purchases			303	60
		32,325	10	32,325	10

Merchandise Inventory. Before the proprietary interest or the result of operating can be determined, the value of the goods on hand must be ascertained. This value is obtained by listing and pricing the goods on hand. The inventory must be used as an asset in getting the proprietary interest and must be deducted from the cost of goods purchased in getting the cost of the goods sold. The inventory at the end of the period, therefore, is used as a real element, affecting capital interest and as a nominal element, affecting the profit. The inventory at the end of the period in the Albert E. Treen business is \$9,395.70.

The following Journal entry is made and posted to the Ledger to record thereon these two elements.

May 31, 19—

Merchandise Inventory	9395.70	
① Purchases		9395.70

To record the inventory on the
books as an asset and to deduct
same from Purchases.

Mixed Accounts. Mixed accounts, as explained previously, are accounts which are partly real and partly nominal. Because of the manner in which the transactions are recorded, the account with Purchases has in it an asset element and an expense element. Purchases has been classified as an expense account and on the working sheet is placed the full amount shown by the trial balance in the Nominal account group as an expense. Since the inventory is an asset, and is included in the amount of the purchases, the asset element must be removed and transferred to an asset account. This is done by an adjusting entry as shown above.

WORKING SHEET
ALBERT E. TREEN

MAY 31, 19→

	Trial Balance May 31, 19—	Nominal		Real	
		Expense	Income	Assets	Liab. + Cap.
Cash	10,346.68			10,346.68	
Otis Bros.	400.—			400.—	
A. R. Dorn	540.—			540.—	
N. O. Kane	1,310.—			1,310.—	
A. S. Simms	780.—			780.—	
Furniture and Furnishings	1,200.—			1,200.—	
Office Appliances	660.—			660.—	
A. K. Klein Co.		800.—			800.—
White Company		660.—			660.—
Lore Mfg. Co.		960.—			960.—
A. S. Lane		1,200.50			1,200.50
A. E. Treen, Cap.		20,000.—			20,000.—
Purchases	15,900.50		15,900.50		
Purchase Returns		520.—	520.—		
Freight, Exp. & Cartage In	146.—		146.—		
Salaries	260.—		260.—		
Rent	120.—		120.—		
Advertising	112.60		112.60		
Telephone and Telegraph	12.60		12.60		
Traveling Expense	220.—		220.—		
Sundry Expense	8.30		8.30		
Discount on Sales	88.42		88.42		
Sales		7,881.—	7,881.—		
Sales Returns	220.—	220.—			
Discount on Purchases		303.60	303.60		
	32,325.10	32,325.10			
Mdse. Inventory ①			9,395.70	9,395.70	
Net Profit		17,088.42	18,100.30	24,632.38	23,620.50
		1,011.88	←	→	1,011.88
		18,100.30	18,100.30	24,632.38	24,632.38

From this working sheet the following statements are prepared:

ALBERT E. TREEN

BALANCE SHEET AS AT MAY 31, 19—

ASSETS

Cash	\$10,346.68	
Otis Bros.	400.00	
A. R. Dorn	540.00	
N. O. Kane	1,310.00	
A. S. Simms	780.00	
Merchandise Inventory	9,395.70	
Furniture and Furnishings	1,200.00	
Office Appliances	660.00	
Total Assets		<u>\$24,632.38</u>

LIABILITIES AND CAPITAL

A. K. Klein Company	\$ 800.00	
White Company	660.00	
Lore Manufacturing Company	960.00	
A. S. Lane	1,200.50	
Total Liabilities	\$3,620.50	
Albert E. Treen, Capital		
Balance	\$20,000.00	
Net Profit	<u>1,011.88</u>	
	21,011.88	
Total Liabilities and Capital		<u>\$24,632.38</u>

ALBERT E. TREEN

PROFIT AND LOSS STATEMENT FOR THE MONTH OF MAY, 19—

Operating Section	Trading Accounts	Gross Sales	\$7,881.00	
		Less — Returns and Allowances	<u>220.00</u> ②	
		Net Sales		\$7,661.00
		Deduct -- Cost of Goods Sold:		
		Gross Purchases	\$15,900.50	
	Operating Exp.	Add — Frt. Exp. & Cart.	<u>146.00</u> ③	
		Total Cost of Purchases	16,046.50	
		Less — Returns & Allow.	<u>520.00</u> ④	
		Cost of Net Purchases	15,526.50	
		Less — Mdse. Inventory May 31, 19—	<u>9,395.70</u> ①	<u>6,130.80</u> ⑤
Non-operating Section		Gross Profit on Sales		1,530.20 ⑥
		Deduct — Operating Expenses:		
		Salaries	260.00	
		Rent	120.00	
		Advertising	112.60	
		Telephone and Telegraph	12.60 ⑦	
		Traveling Expense	220.00	
		Sundry Expense	<u>8.30</u>	<u>733.50</u> ⑦
		Net Operating Profit		796.70
		Add — Other Income:		
		Discount on Purchases		<u>303.60</u> ⑧
		Total Income		1,100.30
		Less — Other Expenses:		
		Discount on Sales		<u>88.42</u> ⑨
		Net Profit for the month of May, 19—		<u>\$1,011.88</u> ⑩

Note: Numbers in circle, ① etc., are numbers of the closing entries which follow. The amounts for the closing entries are all found in the Profit and Loss Statement as indicated above. In making closing entries an entry should be made for each addition and subtraction made in the Profit and Loss Statement. These entries when posted to the Ledger accomplish the transfer of all nominal accounts to the Profit and Loss account. An entry is then made for the net profit which transfers this amount from the Profit and Loss account to the Capital account.

ALBERT E. TREEN

CLOSING ENTRIES

MAY 31, 19—

(Entry ① is found on page 133 of this chapter)

	Sales	220.00	
②	Sales Returns and Allowances		220.00
	To transfer the amount of Sales Returns and Allowances to Sales account.		
	31		
	Purchases	146.00	
③	Freight, Express and Cartage In		146.00
	To transfer the cost of freight, etc., into Purchases account.		
	31		
	Purchase Returns and Allowances	520.00	
④	Purchases		520.00
	To transfer the amount of Purchase Returns and Allowances to Purchases account.		
	31		
	Sales	6,130.80	
⑤	Purchases		6,130.80
	To transfer the Cost of Goods Sold from Purchases to Sales account.		
	31		
	Sales	1,530.20	
⑥	Profit and Loss		1,530.20
	To transfer gross profit from Sales to Profit and Loss account.		
	31		
	Profit and Loss	733.50	
⑦	Salaries		260.00
	Rent		120.00
	Advertising		112.60
	Telephone and Telegraph		12.60
	Traveling Expense		220.00
	Sundry Expense		8.30
	To transfer the amount of operating expenses to Profit and Loss account.		
	31		
	Discount on Purchases	303.60	
⑧	Profit and Loss		303.60
	To transfer the other income to Profit and Loss account.		

MAY 31, 19—

	Profit and Loss	88.42	
⑨	Discount on Sales		88.42
	To transfer the other expenses to Profit and Loss account.		
	31		
	Profit and Loss	1,011.88	
⑩	Albert E. Treen, Capital		1,011.88
	To transfer the net profit to the Proprietor's account.		

The student should check these entries to the Profit and Loss Statement. The above closing entries may be posted to the Model Ledger accounts, and a post closing trial balance taken if desired.

Where there is a Merchandise Inventory account from the previous period, the following accounts are handled as illustrated below:

MERCHANDISE INVENTORY					
19—			19—		
Jan. 1	Balance	10,000	Dec. 31	#1 Inventory	10,000 ①
	(#1 Inventory)			To Purchases	
	(at beginning)				
Dec. 31	Inventory #2	15,000 ②			
	(At end of period)				

The old inventory may be closed into Purchases account at the beginning or at the end of the accounting period. When allowed to remain on the Ledger until the end of the period, it becomes a mixed account until adjusted to the new or Asset Inventory value.

PURCHASES ACCOUNT

19—			19—		
Dec. 31	Purchases during		Dec. 31	Returns & Allow.	1,500
	Year	100,000	Dec. 31	Inventory #2 at	
Dec. 31	Freight In	1,200		end of period	15,000 ②
Dec. 31	#1 Inventory		Dec. 31	Cost of Sales to	
	from Mdse. In-			Sales Account	94,700 ③
	ventory account	10,000 ①			
		<u>111,200</u>			<u>111,200</u>

SALES

19—			19—		
Dec. 31	Ret. Sales	2,000	Dec. 31	Total for year	120,000
Dec. 31	Cost of Sales				
	from Purchases				
	account	94,700 ③			

The balance of the Sales account now shows the gross profit. This is closed to Profit and Loss — See Entry No. 6, page 137.

①, ② These entries would be made to adjust the Inventory and Purchases accounts, where a Merchandise Inventory account shows a balance from a previous period.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Explain the use and classification of the following accounts:

Purchases
 Freight, Express and Cartage In
 Purchase Returns and Allowances
 Merchandise Inventory
 Sales
 Sales Returns and Allowances

2. Why is the Purchases account classified as an expense and the Sales account as an income?

3. Define a mixed account. How does an account become mixed?
4. Explain the entry to bring merchandise inventory at the close of the period on the Ledger.
5. Cash discounts are classified as non-operating financial income or expense. Explain.
6. Describe and explain the form of the Profit and Loss Statement.
7. For what are the following amounts debited and credited? Give a reason based upon the rule for debit and credit for each answer.

Purchases

Freight, Express and Cartage In

Purchase Returns and Allowances

Merchandise Inventory

Sales

Sales Returns and Allowances

Discount on Purchases

Discount on Sales

8. Explain the plan to follow in determining closing entries.
9. What is the advantage of numbering the closing entries?
10. What is the effect on the Ledger of posting the closing entries?
11. Name the operations performed from the opening entries for a set of books to the final trial balance at the end of a period.

CHAPTER X

NEGOTIABLE INSTRUMENTS

Negotiable Instruments. A negotiable instrument is a type of business paper, the use of which is governed by a special law known as the Uniform Negotiable Instruments Act. A negotiable instrument must have the following requisites:

1. It must be in writing and signed by maker or drawer.
2. It must contain an unconditional promise or order to pay a definite sum in money.
3. It must contain the words of negotiability; that is, it must be payable to order or to bearer.
4. It must be payable on demand or at a fixed or definitely determinable future date.
5. Where the instrument is addressed to a drawee, he must be named or otherwise indicated with reasonable certainty.

A business paper complying with the above-named requisites may be transferred from person to person, almost as freely as money, by indorsement and delivery.

Indorsement. An indorsement is the writing by the payee, or a subsequent transferee, of his or her name on the reverse side of the instrument. The first indorsement should be written across the narrow side at the extreme left in accordance with the illustration on page 142.

The indorser must sign his name *exactly* as it is written on the face of the instrument. If the name is misspelled, the indorsement should be written in the same way, and then the person for whom it was intended should sign his

<i>John T. Drury & Co.</i>	Boston, Mass. <u>Nov. 29 1930</u>
	of Boston _____
	To the order of <u>Geo. _____</u> \$ <u>1486.40</u>
	<u>Eighty-six & 40/100</u> Dollars
	<u>Elias Ring</u>

INDORSEMENT OF A CHECK

own name, correctly spelled. Subsequent indorsers sign below the previous indorsement.

Kinds of Indorsement. The forms of indorsement most commonly used are the *blank*, the *full*, the *restrictive*, and the *qualified*.

Blank Indorsement. The blank indorsement consists merely of the name of the indorser written as it is written on the face of the instrument, or, if he is not the payee, in the manner in which he usually signs his name. A negotiable instrument, indorsed in blank, may be subsequently transferred from person to person without further indorsement. The holder of it is recognized as the owner irrespective of whether he obtained it in the ordinary course of business or by finding it or stealing it. An instrument indorsed in blank should, therefore, be guarded carefully until turned into cash. The form on page 142 illustrates a blank indorsement.

Full Indorsement. The indorsement in full consists of the signature of the transferor and his order to pay the

amount of the instrument to a specified person, called the transferee.

Pay to the order of William Smith John H. Lowe
--

An instrument indorsed in full must, to be transferred to another, be indorsed by the person to whom payment is directed by the previous indorsement. (In the above form, William Smith.)

Restrictive Indorsement. A restrictive indorsement consists of the name of the transferor and his order to pay the amount of the instrument to a specified party for a specified purpose. A form of restrictive indorsement is illustrated below:

Pay to the Union National Bank for deposit only John H. Lowe

Pay to the order of Union National Bank for collection John H. Lowe
--

This form of indorsement is advisable when negotiable instruments are sent for deposit. They are then only payable to the person specified who merely acts as agent in collection or for other specified purpose.

Qualified Indorsement. A qualified indorsement consists of the name of the transferee and some qualification or limitation on the liability of the transferor. A form of qualified indorsement is illustrated on page 144.

Pay to the order of Oliver Teel Without recourse to me John T. Drury

The qualification, "without recourse to me," relieves the transferor of liability for payment of the instrument if the maker fails to pay at maturity.

Significance of Indorsement. An indorser, unless he specifically exempts himself by a qualification, contracts that:

1. The instrument transferred is genuine.
2. That he is a holder in due course; that is, that he did not find or steal it.
3. That, if the maker fails to pay the instrument upon proper presentation and demand, he will pay the amount stated on the face of the paper.

Uses of Ordinary Negotiable Instruments. The negotiable instruments which are used commonly in business are:

1. Checks
2. Promissory Notes
3. Drafts
 - (a) Sight
 - (b) Time
 - (c) Trade Acceptance
4. P.O. Money Order
5. Express Money Order

Checks. A check is an order directing a bank to pay from money on deposit a specified sum to the person named on the face. A check presupposes a deposit in the bank, on which the check is drawn, to the credit of the drawer of the

check. Such deposits are kept in so-called commercial banks, and are subject to withdrawal on demand. An illustration of a common form of check is given below:

BOSTON, MASS.	<i>Sept 15</i>	19 <i>30</i>	No. <i>24</i>
THE FIRST NATIONAL BANK OF BOSTON 5-39			
PAY TO THE ORDER OF	<i>William A. Snow</i>	\$ <i>52</i> ^{<i>50</i>} / _{<i>100</i>}	
	<i>Fifty two</i> ^{<i>50</i>} / _{<i>100</i>}		DOLLARS
	<i>L. D. Knight</i>		

SPECIMEN CHECK

Accounting for Checks. Checks received or issued are considered the same as cash and are consequently recorded as cash received or disbursed.

Manner of Making out Negotiable Instruments. Negotiable instruments must be made out carefully in order that the possibilities of error or of alteration may be reduced to a minimum. The name of the payee should be written clearly and correctly. The amount of the instrument in figures should be written in such a way that the amount is clear and difficult to change. The amount written in words should agree with the amount in figures. The first word of the amount should begin near the extreme left of the line intended for this purpose and all blank space filled in with a line.

An illustration of a form of check for less than \$1.00 is given on page 146.

In practice various types of mechanical protectors are used which aid in preventing the alteration of negotiable

BOSTON, MASS.	<u>July 22</u> 19 <u>30</u>	No. <u>124</u>
THE FIRST NATIONAL BANK OF BOSTON 5-39		
PAY TO THE ORDER OF	<u>A. M. Best Company</u>	\$ <u>$\frac{26}{100}$</u>
<u>Only twenty-six cents</u>		<u>Dollars</u>
<u>T. J. Marley</u>		

SPECIMEN CHECK (*less than one dollar*)

instruments. The use of these protectors is to be recommended.

Promissory Notes. A promissory note is a written promise to pay a definite sum of money on a definite or determinable future date to the order of a specified person. Promissory notes may be classified into promissory notes received from others, called *notes receivable* by the receiver, and promissory notes issued by a person or business called *notes payable* by the giver.

Boston, Massachusetts,	<u>Sept 14</u> 19 <u>30</u>	\$ <u>274⁶⁷</u>
<u>Three months</u> after date, for value received, I promise to		
pay to the order of THE FIRST NATIONAL BANK OF BOSTON at said bank		
<u>Two hundred seventy-four $\frac{67}{100}$</u>		<u>Dollars</u>
No. <u>242</u>	<u>12/14/30</u>	Signature <u>Albert D. Snow</u>
Due	Address <u>214 Center Street</u>	
C9		

A PROMISSORY NOTE

General Characteristics of Negotiable Instruments Relating to Notes. A negotiable promise to pay may be transferred from person to person by indorsement and

delivery, and the transferee has full rights to enforce payment. The holder of the note is, therefore, the person to whom the money is payable, and at the time of payment this holder, irrespective of the number of hands it has passed through from the payee to this holder, must be paid the amount of the note. Upon payment, he must surrender the note to the maker.

Due to the transfer of notes from person to person, the person to whom the note is payable is changing with each transfer; consequently, it is not convenient to record notes under the name of a debtor or creditor.

Accounting for Notes Receivable. The written promises to pay received from others are debited, when received, to the Notes Receivable account and the account of the person giving the note is credited. Thus, if a promissory note due in 60 days was received from John K. Dyer, for \$2000, to apply on account, the following entry should be made:

	Date	
Notes Receivable		2000.00
John K. Dyer		2000.00
Received his note dated		
..... due in 60 days to apply		
on account.		

When this note is paid the following entry, expressed in Journal form, should be made:

	Date	
Cash		2000.00
Notes Receivable		2000.00
John K. Dyer paid		
note due to-day.		

Advantages of a Note Receivable over an Account Receivable. A note receivable has the following advantages over an account receivable:

1. It specifies the exact day of payment.
2. It is a written acknowledgment of the indebtedness.
3. It may be used more readily in securing loans at a bank.
4. Because of its more formal character, it is usually paid on the day it is due. Many who do not hesitate to allow their accounts to run past the due date, would not allow a note to become dishonored.
5. If a customer is unable to pay a note at maturity and asks for an extension of time, interest may be charged on the renewal.

Notes Payable. The written promises to pay issued to others are credited to Notes Payable and the corresponding debit is to the account of the person to whom the note is issued. Thus, if a promissory note due in 30 days is issued to William K. Keith, on account, for \$1800 the following Journal entry should be made:

	Date	
William K. Keith		1800.00
Notes Payable		1800.00
Issued note dated		
..... due in 30 days on		
account.		

When this note is paid on the due date, the following entry expressed in Journal form should be made:

	Date	
Notes Payable		1800.00
Cash		1800.00
Paid note issued		
..... to Wm. K. Keith		
on account.		

Notes may be given for purchases or sales of merchandise and run for the term of credit allowed, with no charge for interest. If notes are given in settlement of accounts which are due, the notes should be written with interest.

No record is made in the books for this interest until the note is paid. Entries to record interest are illustrated in the next chapter.

Bills Receivable vs. Notes Receivable. The term *bills receivable* has been used considerably in the past in referring to notes and drafts, and had its origin in the term *bills of exchange*. As the majority of such instruments are, for practical purposes, promissory notes or cash, the title *Notes Receivable* or *Notes Payable* is preferable to use as the title for the account.

Drafts. A draft is an order issued by the creditor requesting the debtor to pay a certain sum of money to a third party or to the creditor himself.

Drafts may be classified as *time drafts* and *sight drafts*.

NO PROTEST TEAR THIS OFF BEFORE PRESENTING

\$ 600.⁰⁰/₁₀₀ Boston, Mass. Nov 22 1930

Sixty days after sight Pay to

the order of Myself

Six hundred and ⁰⁰/₁₀₀ Dollars

at the First National Bank of Boston

Value received and charge to account of

To D. Lacey } James Rice

No. 82 Hartford Conn.

U.S. Government & Co., 107, 109 & 111 Broadway, Boston

AN ACCEPTED TIME DRAFT

Time Drafts. A time draft is an order to pay a certain amount at a specified future date. Inasmuch as it is an order originating with the creditor the instrument has no value until the debtor has indicated his willingness to comply

with the order. The time draft is therefore sent to the debtor for acceptance and is not brought into the accounting records of the creditor until after acceptance. After acceptance by the debtor it becomes virtually a promissory note.

Significance of the Date of Acceptance. In a time draft in which the time is expressed as a certain number of days or months after sight, or merely *at sight*, the date of the acceptance marks the beginning of the time period and is therefore *material*. If the date of acceptance is not inserted, the time period begins with the date of the instrument.

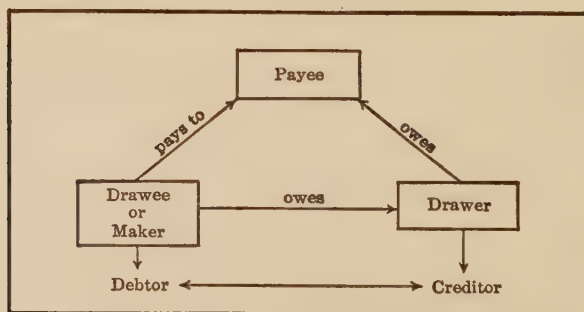
In a time draft in which the time is expressed as a certain number of days or months *after date*, the date of the acceptance is not material because the time period begins with the date of the instrument irrespective of when accepted.

Parties to a Draft. There may be three parties to a draft, namely, the *drawer*, *drawee*, and the *payee*.

The *drawer* is the creditor or the one who issues the order.

The *drawee* is the debtor or the one on whom the order is issued.

The *payee* is the one to whom the instrument is payable. The payee may be the *drawer* or any other person designated by him.



A CHART SHOWING THE RELATION BETWEEN PARTIES TO A DRAFT

A draft in which the drawer, payee, and drawee are all different persons, and between whom there is the relation of debtor and creditor, is called a *three-party draft*.¹ This form of draft is not used to any considerable extent in business to-day because of the universal use of checks, and is not, therefore, discussed at this point.

A draft in which the drawer and payee are the same is called a *two-party draft*. See form on page 149.

Accounting for Two-Party Drafts. At the time of drawing the draft, the drawer merely makes a memorandum of the draft deferring the actual recording until the draft has been returned with the acceptance by the drawee. When the draft is received by the drawer the following entry should be made:

	Date		
Drawer's	Notes Receivable	xxxx	
Entry	Drawee (Name of Drawee)		xxxx
	Received accepted		
	draft due		
	to apply on acc't.		

As stated previously, an accepted draft is virtually a promissory note and consequently it may be recorded in the Notes Receivable account. Inasmuch as notes may or may not be interest-bearing, and drafts are usually not interest-bearing, it may be better, if there are many drafts, to record them in a separate account, called Drafts Receivable.

When the draft is paid, the following entry expressed in Journal form should be made:

	Date		
Drawer's	Cash	xxxx	
Entry	Notes Receivable		xxxx
	Received payment		
	for X's draft due to-day.		

¹ A check is a three-party sight draft. The bank is the *Drawee*.

At the time the draft is accepted the drawee should make the following entry:

	Date		
Drawee's	Drawer (Name of Drawer)	xxxx	
Entry	Notes Payable		xxxx
	Accepted draft		
	drawn by (Drawer)		
	due		

When the draft is paid by the drawee, the following entry expressed in Journal form should be made by him:

	Date		
Drawee's	Notes Payable	xxxx	
Entry	Cash		xxxx
	Paid (Drawer)		
	for draft due to-day.		

Bank Draft. A bank draft is an order, drawn by one bank on another, to pay to the person specified on the draft the amount stated thereon.

BOSTON, MASS., <i>Oct 11 1930</i>	
<u>NATIONAL EXCHANGE BANK 5-46</u>	
Pay to the order of <i>John F. Gilmore</i>	<u>\$342.67</u>
<i>Three hundred forty two</i>	<u>67</u> Dollars
To <u>CASE NATIONAL BANK - 125</u> <u>NEW YORK, N.Y.</u>	<i>L. E. Newhall</i> Cashier

A BANK DRAFT

The accounting for a bank draft is the same as for a payment of cash; no further discussion, therefore, is necessary.

Accounting for Two-Party Sight Draft. A *sight draft* — that is, one payable immediately — is not presented for acceptance, but for payment. The drawer, therefore, makes no entry for the draft at the time of issue. If the draft is paid upon presentation, the entry on both the drawer's and drawee's books is exactly the same as when cash is paid on account.

A rule for accounting for sight drafts may be stated as follows:

Make no entry on either the books of the drawer or drawee until the draft is paid; then make the same entry on the books of each party as would be made for a *payment* in cash.

NO PROTEST TEAR THIS OFF BEFORE PRESENTING.	\$1860 ⁰⁰ / ₁₀₀	Boston, Mass. Nov 26, 1930	
	At Sight	Pay to	
	the order of The First Exchange Bank of Boston, Mass.		
	Eighteen hundred sixty ⁰⁰ / ₁₀₀ Dollars		
	Value received and charge to account of		
To A. L. Bond		John H. Knight	
No. 45 San Diego, Cal.			

A SIGHT DRAFT

Days of Grace. In some States the drawee of a sight draft is allowed three days, called *days of grace*, in which to pay the draft. Inasmuch as the law varies, statutes of a particular State must be consulted.

Trade Acceptances. The trade acceptance is defined by the Federal Reserve Board as a "bill of exchange drawn by the seller on the purchaser of goods which is unconditionally accepted in writing by such purchaser."

The trade acceptance originated in the Federal Reserve Banking Act, and has as an object the freedom of the large amount of inactive capital represented in the open book accounts of business enterprises. Bankers have consistently refused to loan large sums of money on open book accounts because of the risk involved. It was intended that merchants and manufacturers should at the time of a sale of merchandise require the purchaser to accept a trade acceptance due at the expiration of the regular credit period of the business. It acts, therefore, merely as a substitute, at the time of the sale, of a written instrument for an open book account.

The trade acceptances thus received could be taken to the banks and money borrowed on them. The banks in turn who discounted these trade acceptances could, if they were members of the Federal Reserve System, take them to a Federal Reserve Bank and have them rediscounted.

By discounting trade acceptances the merchants and manufacturers obtain their money immediately, and they are thus aided by the banks in financing their business.

A trade acceptance to be eligible for rediscount by the Federal Reserve Banks must possess the following requirements:

1. It must have arisen from an actual current sale or purchase.
2. It must have been drawn under a term of credit opened for the purpose of conducting or settling accounts resulting from business transactions involving the shipment or storage of goods.
3. It must have, at the time of presentation to the Federal Reserve Bank for discount, a maturity of not more than 90 days.

TRADE ACCEPTANCE

No. 472 \$10267.⁸²/₁₀₀

Three months after date New York, N.Y. Jan 16 1930 PAY TO

THE ORDER OF Davis and Clayton

Ten thousand two hundred sixty seven ⁸²/₁₀₀ DOLLARS

VALUE RECEIVED IN FULL CHARGE THE SAME TO ACCOUNT OF

TO Anderson & Lewis

77 Franklin St. } Davis and Clayton
Boston, Mass. } By L.D. Davis

ACCEPTED
 THE SIGNATURE OF THE ACCEPTOR
 THIS WILL BE VALID FOR THE PUR-
 CHASE OF GOODS OR SERVICES
 (AS PER CHOICE)
 120 10 20
 PAYABLE AT
 120 10 20

B 157

A TRADE ACCEPTANCE

Accounting for Trade Acceptances. Trade acceptances are nothing more than time drafts and as such require the acceptance of the drawee. After acceptance the accounting for trade acceptances is similar to the accounting for drafts. Inasmuch as trade acceptances are presumed to be based on current merchandise or business transactions and drafts may or may not be so based, it is better to keep separate account for acceptances using the titles Acceptances Receivable and Acceptances Payable.

The entry on the drawer's books at the time he receives a trade acceptance is:

	Date	
Acceptances Receivable		XXXX
Drawee		XXXX
Received Drawee's		
acceptance due		

When this acceptance is paid, the following entry expressed in Journal form is made:

	Date	
Cash		XXXX
Acceptances Receivable		XXXX
In payment for Drawee's		
acceptance due to-day.		

The entry on the drawee's books at the time of accepting a trade acceptance is:

	Date	
Drawer		xxxx
Acceptances Payable		xxxx
Accepted trade		
acceptance drawn by		
(Drawer) due		

When the drawee pays the acceptance, the following entry expressed in Journal form would be made:

	Date	
Acceptances Payable		xxxx
Cash		xxxx
For trade acceptance		
drawn by (Drawer) due		
to-day.		

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What requisites must a business paper possess in order to be considered negotiable?
2. What is an indorsement?
3. Where should an indorsement be written?
4. What is a blank indorsement? What does it imply?
5. What objections are there to blank indorsements?
6. What is an indorsement in full?
7. What is the advantage of an indorsement in full over a blank indorsement?
8. Explain what is meant by a restrictive indorsement. Illustrate.
9. What is a qualified indorsement?
10. Under what conditions would the transferee accept a qualified indorsement?
11. What is the significance of an indorsement from the viewpoint of the indorser?

12. What are the differences between a note receivable and an account receivable? Which is preferable, and why?
13. Why are notes recorded under the Notes Receivable or Payable accounts and not under the maker's name?
14. Why is Notes Receivable debited when a customer gives a note to apply on account?
15. Why is Notes Payable credited when a note is given to apply on account?
16. Define a draft.
17. In what respects does a draft differ from a promissory note?
18. Explain the meaning of (a) "30 days sight"; (b) "30 days after sight"; (c) "30 days after date."
19. Why is acceptance necessary on a draft?
20. Name and explain the relationship of all the names which may appear on a draft.
21. What is the entry on the drawer's books when he receives an accepted two-party time draft? Why?
22. What is the entry on the drawee's books when he accepts a two-party time draft?
23. What is the difference between a check and a sight draft?
24. What is the meaning of days of grace? Do they allow days of grace in your State?
25. What is a trade acceptance?
26. How does a trade acceptance differ from a time draft?
27. What was the reason for advocating the use of trade acceptances by the Federal Reserve Board?
28. What advantages result from requiring a trade acceptance in place of an open book account?
29. What entry is made on the books of the drawer of the trade acceptance when he receives it accepted? Why?
30. What entry is made on the books of the drawee when he accepts a trade acceptance?

CHAPTER XI

SUBDIVISION OF THE JOURNAL

Journal as the Sole Book of Original Entry. The Journal, up to this point, is the only book in which transactions have been recorded. Every type of transaction, irrespective of the nature and the number of repetitions, has been entered in the Journal. In each entry the name of the debit and the name of the credit have been written and subsequently each debit and credit has been posted individually to the proper accounts in the Ledger.

Thus, in the Model Journal used as an illustration in Chapter IX, pages 122-26, there are, in addition to the other types of transactions not classified, the following types and number of transactions:

Purchases of Merchandise	7
Sales of Merchandise	9
Cash Receipts	6
Cash Payments	13

The recording of these transactions in the Journal required the following:

1. For the seven purchases — the name of the account Purchases was written seven times and there were seven individual postings to the Purchases account.
2. For the nine sales — the name of the account Sales was written nine times and there were nine individual postings to the Sales account.
3. For the six cash receipts — the name of the account Cash was written six times and there were six individual postings to the debit of the Cash account.

4. For the thirteen cash payments — the name of the account Cash was written thirteen times and there were thirteen individual postings to the credit of the Cash account.

The expansion and development of the General Journal is illustrated in this chapter.

Subdivision of Journal in Accordance with Type of Transaction. To eliminate the repetition of similar account names, in recording transactions, the Journal may be subdivided into the following divisions, called Journals, or more commonly, Books:

Purchases Book

Sales Book

Cash Receipts and Payments Book

This is accomplished by taking each of the above classes of transactions out of the General Journal and recording them in separate Books or Journals.

Purchases Book. The Purchases Book is a journal in which all purchases of merchandise are recorded. This book is designed to eliminate the repetition of the name Purchases in recording this class of transactions and to permit the posting of the purchases in one total.

A Purchases Book containing the transactions involving purchases of merchandise, which were entered in the illustrative Journal in Chapter IX, is shown in the accompanying form on page 160.

Entries are usually recorded in this Journal from the purchase invoice received from the seller. The purchase invoice is first compared with the goods actually received, and then the arithmetical calculations are all verified before recording in the Purchases Book.

PURCHASES BOOK

MERCHANDISE PURCHASES FOR THE MONTH OF May, 19....

Day	No.	Account Cr.	Address	Terms	F	Amount Pur. Dr.	Total
3		A. K. Klein Co.	Troy, N.Y.	3/5 n/30	2	6000 00	
5		Lore Mfg. Co.	Prov., R.I.	2/10 n/30	2	4000 00	
13		D. A. Nason	Worcester, Mass.	2/5 n/30	2	2180 00	
22		A. S. Lane	38 Milk St., City	3/10 n/30	3	1600 50	
24		Lore Mfg. Co.	Prov., R.I.	2/10 n/30	2	960 00	
29		A. K. Klein Co.	Troy, N.Y.	3/5 n/30	2	920 00	
31		Cash Purchases			✓	240 00	
31		Purchases Dr.			3		15900 50

Explanation of Purchases Book. For each purchase of merchandise the day of the month is written in the Day column, the name of the account to be credited in the Account Credit space, the address of the vendor in the space headed Address, the terms of the purchase in the Terms space, and the amount of each purchase in the Amount column. At the end of the month the total of the purchases for the month is extended into the Total column, and an entry made debiting Purchases.

The posting of the Purchases Book is as follows:

1. The amount of each individual purchase is posted daily to the credit of the creditor's account, indicated in the Account Credited column.
2. At the end of the month the *total* of the Purchases Debit column is posted in *one* amount to the debit of the Purchases account in the Ledger.
3. In the Folio column is placed the page to which each amount has been posted.

Thus the amounts appearing in the Purchases Debit column are posted individually to the credit of the proper creditor's account and *in total* at the end of the month to the debit of the Purchases account.

The Purchases account in the Ledger after posting of the total purchases at the end of the month should appear as follows:

PURCHASES									
19—									
May	31		P	1	15900	50			

This account should be compared with the Purchases account in the Model Ledger of Chapter IX on page 129. Note particularly that in the account illustrated above there is only one debit and that this debit agrees with the sum of all of the individual debits to the Purchases account on page 129, Chapter IX.

Purchases for Cash and Purchases for Notes. All purchases of merchandise, including purchases of merchandise on account, for cash, and for notes, should be entered at the time of purchase in the Purchases Book. In the case of purchases for cash, the amount is written in the Purchases Debit column and the words Cash Purchases are written in the Account Credit column. This item is checked and not posted as no creditor's account is affected. The credit to correspond to this omitted credit will be Cash, as explained later under the Cash Book.

An account might be opened for Cash Purchases in the Ledger and be considered just as if it were a creditor's account. If this plan is followed, the Cash Purchases account would be credited from the Purchases Book for each cash purchase and debited from the Cash Payments Book.

Purchases for which notes payable are given should be

entered in the Purchases Book just as if they were regular purchases on account, the creditor's account being credited. Then when the note is actually given, an entry is made in the Journal debiting the creditor and crediting Notes Payable.

Sales Book. The Sales Book is a journal in which all sales of merchandise are recorded. This book is designed to eliminate the repetition of the writing of the name Sales in recording transactions and to permit the posting of the sales in one total rather than individually.

A form of Sales Book is illustrated below. The transactions involving sales of merchandise which were entered in the illustrative Journal in Chapter IX are recorded in this form.

SALES BOOK

MERCHANDISE SALES FOR THE MONTH OF May, 19....

Day	Bill No.	Account Dr.	Address	Terms	F	Sales Cr.	Total
6		Otis Bros.	25 West St.	2/10 n/30	1	1820 00	
8		E. T. Sadler	242 Union St.	2/10 n/30	1	960 40	
12		A. R. Dorn	47 Halifax St.	2/10 n/30	1	1280 60	
13		G. R. Selden	Cambridge	2/10 n/30	1	360 00	
16		Cash Sales			✓	210 00	
18		A. S. Simms	Wellesley, Mass.	n/30	2	780 00	
23		N. O. Kane	374 Main St.	2/10 n/30	1	1310 00	
24		A. R. Dorn	47 Halifax St.	2/10 n/30	1	700 00	
27		Otis Bros.	25 West St.	2/10 n/30	1	460 00	
31		Sales Credit			3		7881 00

Explanation of Sales Book. For each sale of merchandise the day of the month is written in the Day column, the name of the account to be debited in the Account Debited space, the address of the vendee in the space headed Ad-

dress, the terms of the sale under Terms, and the amount of each sale in the Sales Credit column. At the end of the month the total of the sales for the month is extended into the Total column, and an entry made crediting Sales.

The posting of the Sales Book is as follows:

1. The amount of each individual sale is posted daily to the debit of the debtor's account, indicated in the Account Debited space.
2. At the end of the month the total of the Sales Credit column is posted in one amount to the credit of the Sales account in the Ledger.
3. In the Folio column is placed the page to which each amount has been posted.

Thus the amounts appearing in the Sales Credit column are posted individually to the debit of the proper debtor's account and in total at the end of the month to the credit of the Sales account.

The Sales account in the Ledger after posting of the total sales at the end of the month would appear as follows:

SALES									
				19—					
				May	31		S	1	7881 00

This account should be compared with the Sales account in the Model Ledger of Chapter IX, page 130. Note particularly that in the account illustrated above there is only one credit and that this credit agrees with the sum of all the individual credits to the Sales account on page 130, Chapter IX.

Cash Sales and Sales for Notes. All sales of merchandise, including sales for cash and for notes as well as sales on account, should be entered in the Sales Book.

In the case of sales for cash, the amount of the sale is written in the Sales Credit column and the words *Cash Sales* written in the Account Debited column. A check mark is placed beside this item in the Folio column to indicate that it is not to be posted. The debit corresponding to this omitted debit will be Cash, as explained later under Cash Book.

An account might be opened for Cash Sales in the Ledger and this account considered just as if it were a customer's account. If this plan is followed, the Cash Sales account would be debited from the Sales Book for each cash sale and credited from the Cash Receipts Book.

Sales in payment for which notes are received are entered at the time of the sale just as a sale on account, debiting the name of the person to whom the sale is made. When the note is actually received a General Journal entry is made, debiting Notes Receivable and crediting the name of the customer.

Cash Book. The Cash Book is a journal in which all cash transactions are recorded. The Cash Book consists of two sides, the left or receipt side and the right or payment side. The receipt side is designed to eliminate the repetition of the writing of the name Cash every time cash is received and to permit the posting in one amount of all the cash received during a period. The payment side is designed to eliminate the repetition of the writing of the word Cash every time cash is paid and to permit the posting in one amount of all the cash paid during a period.

A form of Cash Book is illustrated on pages 166-67, showing entries taken from the illustrative Journal in Chapter IX.

Explanation of Receipt Side of Cash Book. Each receipt of cash is entered on the left or receipt side of the Cash Book. The day is written in the Day column, the name of the account to be credited in the Account Credited space, a brief explanation in the Explanation space, and the amount of cash actually received in the Cash Debit column. At the end of the month the total cash received during the month is extended into the Total column, and an entry made debiting Cash.

The posting from the receipt side of the Cash Book is as follows:

1. The amount of each receipt of cash is posted individually to the credit of the account entered in the Account Credited space. The page of the Ledger to which the amount is posted is entered in the Folio column.
2. At the end of the month the total of the cash received for the month is posted to the debit of the Cash account in the Ledger. The page of the Ledger to which it is posted is entered in the Folio column.

The amounts appearing in the Cash Debit column are thus posted individually to the credit of the accounts entered in the Account Credit space, and, in total, to Cash.

Explanation of Payment Side of Cash Book. Each payment of cash is entered on the right or payment side of the Cash Book. The day is written in the Date column, the name of the account debited in the Account Debit space, the explanation in the Explanation space, and the amount of cash paid in the Cash Credit column. At the end of the month the total cash paid out during the month is extended into the Total column, and an entry made crediting Cash.

CASH BOOK

Cash Received				Month of May 19—			
	Date	Account Credited	Explanation	F	Cash Dr.	Total	
	May 1	Albert E. Treen — Cap.	Investment	3	20000 00		
	16	Cash Sales		✓	210 00		
	16	Otis Bros.	Inv. 5/6 \$1820 less 2%	1	1783 60		
	18	E. T. Sadler	Inv. 5/8 960.40 " 2%	1	941 19		
	22	A. R. Dorn	Inv. 5/12 1280.60 " 2%	1	1254 99		
	23	G. R. Selden	Inv. 5/13 360.00 " 2%	1	352 80		
	31	Cash Debit		1		24542	58
						24542	58
	June 1	Balance				10346	68

The posting from the payment side of the Cash Book is as follows:

1. The amount of each payment of cash is posted individually to the debit of the account entered in the Account Debit space. The page of the Ledger to which each account is posted is entered in the Folio column.
2. At the end of the month the total of the cash paid out for the month is posted to the credit of the Cash account in the Ledger. The page of the Ledger to which it is posted is entered in the Folio column.

The amounts appearing in the Cash Credit column are thus posted individually to the debit of the account entered in the Account Debit space, and, in total, to Cash.

CASH BOOK

Cash Payments

Month of May 19—

Date	Account Debited	Explanation	F	Cash Cr.	Total
May 2	A. K. Klein Co.	Inv. 5/3 \$6000 less 3%	2	5820 00	
10	Advertising	Newspaper Ad'vt	4	112 60	
12	White Co.	In full	2	1200 00	
15	Rent	For May	4	120 00	
15	Lore Mfg. Co.	Inv. 5/5 \$4000 less 2%	2	3920 00	
16	Salaries	Two weeks	4	130 00	
18	D. A. Nason	Inv. 5/13 \$2180 less 2%	2	2136 40	
23	Sundry Expense	Cleaning & Sweeping	4	8 30	
31	Cash Purchases		✓	240 00	
31	Salaries	Two weeks	4	130 00	
31	Telegraph & Telephone	Installation	4	12 60	
31	Traveling Expense	Expense for Month	4	220 00	
31	Fr., Exp. & Cartage In	Bills for Month	4	146 00	
31	Cash Credit		1		14195 90
	Balance of cash on hand	May 31			10346 68
					24542 58

The Cash account in the Ledger after posting of the totals from the Cash Book should appear as follows:

CASH

19—					19—				
May 31		C 1	24542	58	May 31		C 2	14195	90

This account should be compared with the Cash account in the Model Ledger of Chapter IX on page 127. Note particularly that in the account illustrated above there is

only one debit and that this debit corresponds to the total of the individual debits in the Cash account on page 127, also that there is only one credit to the Cash account illustrated above, which is equal to the total of the individual credits in the Cash account on page 127.

Cash Sales and Cash Purchases. The cash received from cash sales is entered on the receipt side of the Cash Book and in the Account Credit space the words *Cash Sales* are written. A check mark is placed beside this item in the Folio column to indicate that it is not to be posted. When this sale was recorded in the Sales Book, it was checked and not posted to the debit of any account. A debit posting was, therefore, omitted from the Sales Book and a credit posting from the receipts side of the Cash Book. The omission of these postings does not affect the equilibrium of the Ledger and the final effect of the two entries is a debit to Cash and a credit to Sales.

The cash paid for merchandise purchases is entered on the payment side of the Cash Book and in the Account Debit column the words *Cash Purchases* are written. A check mark is placed beside this item in the Folio column to indicate that it is not to be posted. When this purchase was recorded in the Purchases Book, it was checked and not posted to the credit of any account. A credit posting, therefore, was omitted from the Purchases Book and a debit posting from the payment side of the Cash Book. The omission of these postings does not affect the equilibrium of the Ledger and the final effect of these entries in both books is a debit to Purchases and a credit to Cash.

General Journal. When the special journals as illustrated and explained in the previous pages are used, the General Journal contains the remaining transactions which

do not occur frequently enough to warrant a special journal. The General Journal also contains entries made to correct errors and, at the close of a fiscal period, the adjusting and closing entries.

In the form on pages 169-70, the remainder of the transactions which were entered in the Model Journal of Chapter IX are entered in the General Journal. These transactions, since no special journal is provided for them, remain in the General Journal.

It should be noted that the General Journal receives its name from the fact that miscellaneous or general transactions are recorded therein.

When only one journal is used, all transactions are recorded in it. When special journals are used, all transactions of the same kind are taken out of the General Journal and recorded in a special journal. Each journal receives its name from the class of transactions entered therein; as Sales, Purchases, Cash.

All transactions which are not in a special class are entered in a General Journal.

As the special journals increase in number, the transactions remaining to be entered in the General Journal decrease.

MAY 1, 19—

	Albert E. Treen this day begins business on his own account, dealing in carpets, rugs, and floor coverings. He rents a store at 80 Port St., and agrees to pay on the fifteenth day of each month a rental of \$120. He invests cash \$20,000. -1- Furniture and Furnishings White Co. Terms, net cash.						
						1200 00	
							1200 00

MAY 8, 19—

A. K. Klein Co.	180 00	
Discount on Purchases		180 00
Discount of 3% on invoice of 5/3 for \$6000.		
-15-		
Lore Mfg. Co.	80 00	
Discount on Purchases		80 00
Discount of 2% on invoice of 5/5 for \$4000.		
-16-		
Discount on Sales	36 40	
Otis Bros.		36 40
Discount of 2% on sale of 5/6, for \$1820.		
-18-		
D. A. Nason	43 60	
Discount on Purchases		43 60
Discount of 2% on invoice of 5/13.		
-18-		
Discount on Sales	19 21	
E. T. Sadler		19 21
Discount of 2% on sale of 5/8.		
-20-		
Office Appliances	660 00	
White Co.		660 00
Typewriters and adding ma- chine. Terms, n/30.		
-22-		
Discount on Sales	25 61	
A. R. Dorn		25 61
Discount of 2% on sale of 5/12/19—, for \$1280.60.		
-23-		
Discount on Sales	7 20	
G. R. Selden		7 20
Discount of 2% on sale of 5/13, for \$360.		
-26-		
Sales Returns and Allowances	160 00	
A. R. Dorn		160 00
Return of part of sale of 5/24.		

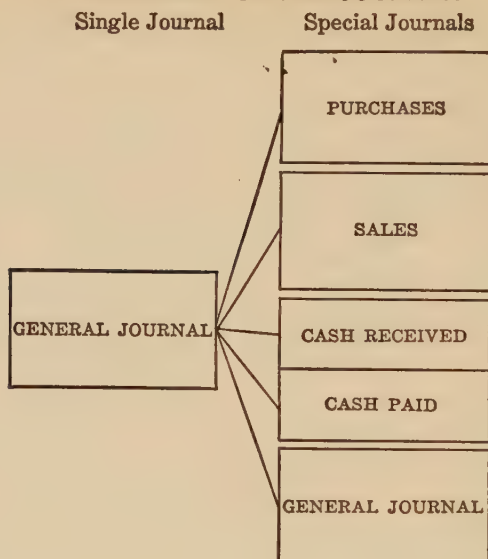
MAY, 27, 19—

A. S. Lane	400	00		
Purchase Returns and Allowances			400	00
Return part of purchase of 5/22.				
-31-				
Sales Returns and Allowances	60	00		
Otis Bros.			60	00
Allowance for defective goods				
in sale of 5/27				
-31-				
A. K. Klein Co.	120	00		
Purchase Returns and Allowances			120	00
Allowance for defective goods				
in purchase of 5/29.				

Advantages of Subdivision of Journal. The advantages resulting from the subdivision of the Journal are:

1. *Labor-saving.* Saving of time and labor in the recording and the posting of transactions.
2. *Transactions classified.* The entering of transactions of a given type in a special journal provides a classification of transactions which is valuable as a reference.
3. *Subdivision of Labor.* Permits the distribution of the accounting work to more than one employee.
4. *Saves space in the Ledger.* One posting in total amount is made to an account for a great number of entries. This makes the Ledger more condensed. The same information is furnished as before, but the details of certain accounts are in the special journals.

DEVELOPMENT OF THE JOURNAL



MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What classes of transactions occur with great frequency in business?
2. It is evident that much time is consumed in writing the name of the account debited and the account credited in each transaction in the Journal. Explain how this work is shortened by the use of special journals.
3. It is also evident that in posting much time is consumed in transferring each and every debit and credit for every transaction to the Ledger accounts. Explain how the time used in posting is shortened by using special journals.
4. How does the appearance of the Purchases account in the Ledger change because of the use of special journals? Sales account? Cash account?

5. Explain the posting of the Purchases Journal.
6. Explain the posting of the Sales Journal.
7. Explain the posting of the Cash Receipts Journal.
8. Explain the posting of the Cash Payments Journal.
9. How is the General Journal affected by this special journal development?
10. What transactions are recorded in the General Journal where special journals, as illustrated, are used?
11. Some transactions such as Cash Sales and Cash Purchases are entered in two journals. Explain.
12. Explain the difference between General Journal (standard form) entries, and special journal entries.
13. Are special journal entries equal as to debit and credit at all times? Explain.
14. How is the Ledger affected by the special journal development?
15. State the advantages of subdividing the Journal.

CHAPTER XII

BANKING RELATIONS, INTEREST, AND DISCOUNT

Functions of Commercial Banks. A commercial bank, from the viewpoint of business, is an institution for the deposit of funds, the maintaining of checking accounts, the collection of drafts and other negotiable paper, and the lending of money on proper security.

The value of the service rendered by the commercial bank to business is incalculable and is becoming each year more and more comprehensive. Commercial banks realize that their existence is dependent upon business and their prosperity is proportionate to the prosperity of the business which they serve. These banks have, therefore, spared neither effort nor money in improving and extending the service which they render to their customers.

A person or business in establishing banking relations should select a bank which is best fitted, from the viewpoint of resources and organization, to render the maximum service to that *particular* person or business.

Opening of a Checking Account. After a decision has been reached regarding the bank with which banking relations are to be established, the prospective customer should be introduced to the bank officials by some responsible person known to both parties. Banking relations require the utmost good faith, and banks usually require all prospective customers to be vouched for by some responsible party.

The opening of the bank account is accomplished by the filling-out of a signature card or cards, and a deposit of funds by the customer.

The signature card contains the name of the account and the signature of the person or persons who are authorized to draw money from the bank by check. The signature on

the signature card must be the one used in all the relations with the bank. A form of signature card is illustrated below:

Individual or Firm _____	
JAMAICA TRUST COMPANY, BOSTON, MASS.	
Authorized Signature _____	
Business Address _____	'Phone _____
Residence Address _____	'Phone _____
Introduced by _____	
Reference _____	
Remarks _____	
Date _____	Deposit \$ _____

The bank will honor only checks or orders which are signed *exactly* as on the signature card. Care should be taken to write the name the same way each time a check is signed. The bank is responsible for any money paid out by it on the order of any customer, and will not pay any money unless the signature agrees with that on the card. In case of a change in manner of signature, or of person who is to sign, a new signature card must be filled out.

Deposit Slips. A deposit is made by filling in a deposit slip. These forms are furnished by the banks. When properly filled out, the money and the deposit slip are handed to the receiving teller of the bank. He then, after verification, enters the deposit in a pass book provided by the bank and gives the pass book and a check book to the customer.

JAMAICA TRUST COMPANY

DEPOSIT TO THE CREDIT OF

19

IN RECEIVING ITEMS FOR DEPOSIT OR COLLECTION, THIS COMPANY ACTS ONLY AS DEPOSITOR'S COLLECTING AGENT AND ASSUMES NO RESPONSIBILITY BEYOND THE EXERCISE OF DUE CARE. ALL ITEMS ARE CREDITED SUBJECT TO FINAL PAYMENT IN CASH OR SOLVENT CREDITS. THIS COMPANY WILL NOT BE LIABLE FOR DEFAULT OR NEGLIGENCE OF ITS DULY SELECTED CORRESPONDENTS NOR FOR LOSSES IN TRANSIT, AND EACH CORRESPONDENT SO SELECTED SHALL NOT BE LIABLE EXCEPT FOR ITS OWN NEGLIGENCE. THIS COMPANY OR ITS CORRESPONDENTS MAY SEND ITEMS, DIRECTLY OR INDIRECTLY, TO ANY COMPANY INCLUDING THE PAYOR, AND ACCEPT ITS DRAFT OR CREDIT AS CONDITIONAL PAYMENT IN LIEU OF CASH: IT MAY CHARGE BACK ANY ITEM AT ANY TIME BEFORE FINAL PAYMENT, WHETHER RETURNED OR NOT, ALSO ANY ITEM DRAWN ON THIS COMPANY NOT GOOD AT CLOSE OF BUSINESS ON DAY DEPOSITED.

	DOLLARS	CENTS
BILLS _____		
SPECIE _____		
CHECKS AS FOLLOWS		
Please state name of bank on which local checks are drawn: All others name of place only. Endorse all checks and drafts.	TOTAL	

A specimen deposit slip with details of the deposit is illustrated below, reduced in size:

Each check must be listed separately either on the deposit slip or on a supplementary slip attached thereto. The

checks are listed in accordance with the name or location of the bank on which they are drawn. If the bank on which the check is drawn is located in the same city as the bank in which the deposit is being made, the *name* of the bank is used in listing. If the check is drawn on a bank located in some city other than the one in which the deposit is being made, the name of the *city* is used in listing the checks.

Deposit slips are used by the banks as the record from which postings are made to the depositors' accounts. They should, therefore, be made out very carefully so that no confusion will result in the identity of the depositor or in the amount of the deposit.

Universal Numerical System of the American Bankers' Association. In 1910, the Clearing-House Section of the American Bankers' Association, realizing the necessity for a uniform system of bank numbers, which would provide every bank in the United States with a definite number of its own, evolved and worked out the details for numbering all the banks in the country. The Executive Council of the American Bankers' Association at its meeting in Nashville, Tennessee, May 2, 1911, unanimously adopted this Universal Numerical System and authorized the publication of a book containing the names and numbers of all banks in the United States.

Under this plan each of the Reserve cities (also, because of their size and importance, Buffalo, N.Y., and Memphis, Tenn.) is designated by a number, called a *prefix* number. The cities are numbered 1 to 49, inclusive, in order of their population according to the Government Census of 1910. The lower numbers were thus assigned to the larger cities. The *prefix* numbers 50 to 99, inclusive, are assigned to the States and Territories, exclusive of the cities which have numbers, and are called Reserve cities.

bered in consecutive order according to seniority in each city or town. Where there is but one bank in the town, it is numbered in alphabetical order according to towns. These bank numbers are called *transit* numbers.

[illegible]

Commercial banks, national banks, trust companies, and savings banks are included in the number system. The treasurer and the assistant treasurers of the United States and the post offices in the cities were also numbered.

Thus, 1-12 indicates bank number 12 in New York City, the Chemical National Bank; 5-12 indicates bank number

12 in Boston, Massachusetts, the Atlantic National Bank; 26-1 indicates bank number 1 in Memphis, Tennessee, the Bank of Commerce and Trust Company; 50-76 indicates bank number 76 in the State of New York, First Bank and Trust Company of Utica, New York; 53-137 indicates the Holyoke National Bank of Holyoke, Massachusetts, etc.

The banks use these numbers in recording items in transit, and recommend and prefer that the depositors use these numbers in making out deposit slips instead of writing the name of the bank or the city or town in which the bank is situated.

Bank Pass Book. The bank pass book is used by the bank in recording each deposit made by the depositor. The depositor hands the pass book to the receiving teller with each deposit and the receiving teller enters the amount of the deposit in the pass book.

It was formerly customary to turn the pass book in to the bank, at the end of each month, to have it balanced, but now most banks issue monthly statements to their customers which eliminates the balancing of the pass book.

Duplicate Deposit Tickets. Many patrons of banks use, instead of a bank pass book, duplicate deposit slips which are furnished by the bank in book or pad form. These duplicate deposit slips have the advantage of showing the full details of each deposit, thus being very valuable as a reference in case any question arises concerning a deposit. These duplicate deposit slips which are usually receipted by the teller may be filed chronologically and thus be referred to and audited much more readily.

The Check Book. The bank, at the time of opening an account, provides the depositor with a check book. The form of check book varies according to the requirements of

the depositor and the practice of the bank. The most common form of check book consists of a bound book of perforated sheets, the right section of which is the check proper and the left section is the stub or the memorandum of the check.

A model of this form of check-book page is illustrated below:

CHECKS AND STUB

Forward No. _____	Boston, Mass. _____ 19 ____ No. _____ FIRST NATIONAL BANK 5-39
_____ 19 ____	

\$ _____	Pay to the order of _____ \$ _____ _____ Dollars
No. _____	Boston, Mass. _____ 19 ____ No. _____ FIRST NATIONAL BANK 5-39
_____ 19 ____	

\$ _____	Pay to the order of _____ \$ _____ _____ Dollars
No. _____	Boston, Mass. _____ 19 ____ No. _____ FIRST NATIONAL BANK 5-39
_____ 19 ____	

\$ _____	Pay to the order of _____ \$ _____ _____ Dollars

Except where duplicate deposit slips are used, the deposits are entered in detail on the reverse side of the previous check stub and the amount carried over on the stub of the unused check. Then each check, as written, is sub-

tracted from the balance of the deposit. When another deposit is made, it is added to the balance remaining in the bank as shown on the stub of the last check written.

Another method is to carry the deposits and balance on the back of the previous check stub. From this total is subtracted the sum of the three checks issued. This remainder, representing the balance in the bank, is then carried forward to the back of the next stub.

Other methods of handling the bank balance are used where the deposits and checks are recorded in a separate record or sheet and a daily balance carried forward.

The methods used in keeping the balance in the checking account vary widely, dependent upon the accounting system in use. Irrespective of the method used, every business should keep such a record of its checking account, that it may determine at any time the balance in the bank. At the end of the month, the balance shown by the records of the business should be reconciled with the balance shown on the monthly bank statement.

Bank Statements. Practically all banks, *at the close of their business month*, prepare monthly statements of their depositors' commercial accounts. These statements give a summary of the month's transactions between the bank and the depositor. They show the balance on hand at the beginning of the month, the deposits and other credits during the month, the checks issued by the depositor which have passed through the bank, other charges made by the bank during the month, and the balance on hand at the end of the month.

A form of bank statement is illustrated below:

COLONIAL TRUST COMPANY

BOSTON, MASS.

L. M. Graham

W. J. Graham

61 Rockview St. J. P.

Statement of your account for May 1930

Checks in Detail			Date	DEPOSITS	Date	Balance
			BALANCE BR'T FOR'D		May 1 '30	130.73
3.94	50.62		May 1 '30		May 1 '30	76.17
			May 1 '30	365.00	May 1 '30	441.17
3.96			May 2 '30		May 2 '30	437.21
2.00			May 4 '30		May 4 '30	435.21
11.45	3.67	20.00	May 4 '30		May 4 '30	400.09
68.76			May 7 '30		May 7 '30	331.33
40.00			May 9 '30		May 9 '30	291.33
25.00			May 12 '30		May 12 '30	266.33
40.00			May 12 '30		May 12 '30	226.33
			May 13 '30	71.56	May 13 '30	297.89
20.00			May 15 '30		May 15 '30	277.89
			May 15 '30	Int. 2.10	May 15 '30	279.99
2.50			May 16 '30		May 16 '30	277.49
3.70			May 18 '30		May 18 '30	273.79
13.37			May 20 '30		May 20 '30	260.42
20.00	1.76		May 20 '30		May 20 '30	238.66
26.70			May 21 '30		May 21 '30	211.96
			May 22 '30	235.00	May 22 '30	446.96
3.96			May 22 '30		May 22 '30	443.00
4.87			May 23 '30		May 23 '30	438.13
12.25			May 25 '30		May 25 '30	425.88
25.00			May 25 '30		May 25 '30	400.88
4.30			May 27 '30		May 27 '30	396.58
25.00			May 29 '30		May 29 '30	371.58
27.02			May 29 '30		May 29 '30	344.56
			May 29 '30	147.98	May 29 '30	492.54

Key

Lst — List

Col — Collection

Rt — Return

.00* — Closed acc't

OD — Overdraft

PLEASE EXAMINE AT ONCE

If no errors are reported in
ten days the account will be con-
sidered correct.

THE LAST AMOUNT IN
ABOVE COLUMN IS
YOUR BALANCE

Reconciliation of Bank Statement Balance and the Check Book Balance. The balance on hand at the end of a month according to the bank statement rarely agrees with the balance shown in the check book. The checks are deducted from the balance in the check book as they are *issued*, but are not deducted by the bank until they are presented to the bank for payment. There is generally a period of one or two days and frequently a longer period between the date a check is issued and its presentation to the bank for payment.

Many banks allow interest on checking accounts. This interest is added to the account by the bank during the month and is shown in the deposit section of the bank statement. Some banks charge what is known as a "service charge" on accounts, the daily average of which is less than the minimum fixed by the bank. This service charge is included as a deduction on the monthly bank statement with the checks which have passed through the bank. Checks which are deposited and returned because of lack of funds in drawee's bank are charged back by the bank.

Banks have arrangements with customers at times to accept deposits after banking hours. Such deposits are not entered on the bank records until the next day. Consequently, deposits of this kind, made on the last day of the month, would not appear on the bank statement until the succeeding month.

The following case is used to illustrate the process of reconciling the balance on the bank statement with the balance in the check book:

The check book of S. A. Doran shows, on March 31, 193-, a balance of \$9,926.10. The bank statement of March 31 shows a balance of \$11,167.50. After checking the cancelled checks returned by the bank with the record of the

checks which were issued, it was found that the following checks were not yet presented to the bank for payment:

#746	\$1367.50	
#863	460.60	
#864	970.20	
#865	310.00	\$3108.30

A deposit of \$1,670.50 made after banking hours on March 31, 193-, which was not credited to the account by the bank until April 1, was included in the check book balance. The bank allowed \$3.60 interest on the average daily balance for the preceding month. A customer's check included in our deposit of March 29, 193-, for \$200.00 was returned marked "no funds."

RECONCILIATION OF BALANCE PER BANK STATEMENT WITH THE CHECK BOOK

Method No. 1

Balance per Bank Statement March 31, 193-	\$11,167.50	
Add — Deposit of March 31, not credited	1,670.50	
Total Balance in Bank March 31	12,838.00	
Less — Outstanding checks:		
#746	\$1,367.50	
#863	460.60	
#864	970.20	
#865	310.00	3,108.30
Adjusted Bank balance March 31		\$9,729.70
Balance per check book March 31	9,926.10	
*Add — Interest credited on daily balances	3.60	
	9,929.70	
*Less — Dishonored check included in deposit of March 29	200.00	
Adjusted check book balance March 31		<u>\$9,729.70</u>

* Entries for these items should be made on the check book stub and in the cash journal, no entry having been made because information concerning these transactions was lacking until the bank statement was verified as above.

Method No. 2

Balance per check book		\$9,926.10	
*Add — Interest on daily balances		3.60	
		<u>9,929.70</u>	
*Less — Dishonored check — X Co. — returned		200.00	
Adjusted check book balance		<u>9,729.70</u>	
Add — Outstanding Checks.			
#746	\$1,367.50		
#863	460.60		
#864	970.20		
#865	310.00	3,108.30	
Adjusted Bank Balance			\$12,838.00
Balance per Bank Statement	\$11,167.50		
Add — Deposit not credited	1,670.50	12,838.00	
Balance O. K.			

* Entries for these items should be made on the check book stub and in the cash journal, no entry having been made because information concerning these transactions was lacking until the bank statement was verified as above.

Either method may be used. The first method works from the bank statement balance back to the adjusted check book balance. The second method starts with the check book balance and works to the adjusted bank balance.

The bank statement balance should be reconciled each month with the check book balance. While it is true that banks prepare a trial balance every day, and that all the work for the day is supposed to be proved, yet it must be remembered that these proofs are proofs of totals only and do *not* reflect errors in individual accounts. The prompt notification of errors in individual accounts aids the bank in making the proper adjustments.

Wherever possible, it is desirable to have some one other than the one handling the finances do the reconciling of the bank statement. This policy tends to make irregularities in the handling of the finances more difficult.

INTEREST AND DISCOUNT

Interest-Bearing Negotiable Instruments. Negotiable instruments, particularly notes receivable and payable, very frequently bear interest. Such instruments are called *interest-bearing paper*. The interest is payable at the maturity of the paper at the rate stated on its face. If interest is to be paid on an instrument it must be so stated on the paper. In other words, an instrument is assumed to be non-interest-bearing unless it is stated to the contrary.

If on interest-bearing paper, the words "with interest" are used without specifying the rate to be paid, then the legal rate of interest fixed by the State is assumed.

Interest Calculations. Interest calculations, in business, are usually based on a year of 360 days, or 12 months of 30 days each, which is called the *commercial year*. The interest so calculated is called *ordinary interest* or *bankers' method*.

The method of calculating ordinary interest may be expressed by the formula:

$$\text{Principal} \times \text{Time} \times \text{Rate} = \text{Interest}$$

This formula may be illustrated by the solution of the following problem:

Ordinary Interest. Find the interest on \$4,200.00 for 60 days at 6%.

Substitute the terms in this problem in the equation expressing the time and rate as common fractions.

$$4200.00 \times \frac{60}{360} \times \frac{6}{100} = 42.00 \text{ ordinary interest.}$$

Inasmuch as the principal, in finding the interest for 60 days at 6%, is always multiplied by $\frac{60}{360} \times \frac{6}{100}$, which is equal to $\frac{1}{100}$ or .01, the interest for 60 days at 6% may be

found by multiplying the principal by $\frac{1}{100}$, which is accomplished by moving the decimal point two places to the left.

Sixty-Day 6% Rule. The ordinary interest on any principal for 60 days at 6% may be calculated by moving the decimal point in the principal two places to the left.

Six-Day Interest. Since the principal, in finding the interest for 6 days at 6%, is always multiplied by $\frac{6}{360} \times \frac{6}{100}$, which is equal to $\frac{1}{1000}$ or .001, the interest for 6 days at 6% may be found by multiplying the principal by $\frac{1}{1000}$, which is accomplished by moving the decimal point three places to the left.

Six-Day 6% Rule. The ordinary interest on any principal for 6 days at 6% may be calculated by moving the decimal point in the principal three places to the left.

These rules may be applied in finding the interest for any time at 6% by first finding the interest for 6 or 60 days at 6% and then increasing or decreasing the interest thus found by the proportion that the given time exceeds or is less than 6 or 60 days. Likewise they may be extended to the finding of the interest at any rate for any time by first finding the interest for the given time at 6% and then increasing or decreasing the interest for the given time (at 6%) by the fraction that the given rate exceeds or is less than 6%.

Exact Interest. Exact interest is the correct interest for any specified time. It is figured on the basis of a 365- or 366-day year, as the case may be.

For example, the interest for one year at 6% is .06 of the principal, and is exact. If we are figuring a time shorter than a year, the exact proportion of the full year's interest is the exact interest.

To illustrate: The exact interest on \$465.00 for 60 days at 6% would be:

$$\frac{\$465.00 \times .06 \times \overset{12}{\cancel{60}}}{\underset{73}{365}} = \frac{\$334.80}{73} = \$4.59;$$

whereas the interest on the above amount by the bankers' method for the same time at 6% would be:

$$\frac{\$465.00 \times .06 \times \overset{.01}{\cancel{60}}}{\underset{\cancel{6}}{360}} = \$4.65$$

The difference between the calculations above illustrated is .06. The ratio of difference between the interest on a 360-day basis and a 365-day basis is $\frac{5}{365}$ or $\frac{1}{73}$.

It is evident, therefore, that exact interest is approximately $\frac{1}{73}$ less than ordinary interest.

Because of the greater ease in calculating interest by the 60-day and 6-day rules at 6%, ordinary interest is common in business. The difference is so small that there is very seldom any question as to the method used in calculation of interest. In large dealings, exact interest may be used if requested.

Accounting for Interest-Bearing Notes Receivable. No entry is made for the interest until the maturity of the note and payment is received. The account which is used to record the interest earned on Notes Receivable is Interest Income. This account, as its name indicates, is an income account and is credited for interest received.

The recording of Notes Receivable and the use of the Interest Income account may be illustrated by means of the following transactions:

A note receivable for \$1800.00 is received from George Teele on January 21, 19—, due in 3 months, with interest at 6%, to apply on account. . . .

At the time the note is received the following entry is made:

January 21, 19—	
Notes Receivable	1800.00
George Teele	1800.00
Received his note dated 1/21 due in 3 months with interest at 6%.	

This note would be due on the 21st day of the third month after January; that is, April 21.

On April 21, when this note is paid, the following entry expressed in journal form is made:

April 21, 19—	
Cash	1827.00
Notes Receivable	1800.00
Interest Income	27.00
In payment for Geo. Teele's 3 months' note with interest at 6% due to-day.	

The interest is calculated as follows:

Interest on 1800.00 for 60 days at 6% = 18.00

Interest on 1800.00 for 30 days at 6% = 9.00

Interest on 1800.00 for 90 days at 6% = 27.00

Accounting for Interest-Bearing Notes Payable. The account used to record the interest paid is Interest Expense. This account, as its name indicates, is an expense account and is *debited* for interest paid on negotiable instruments.

The recording of notes payable and the use of the account Interest Expense may be illustrated by the following transactions:

A note payable is given to L. K. King on February 26, 19—, due in 2 months, for \$2400.00 with interest at $5\frac{1}{2}\%$, to apply on account.

At the time the note is issued the following entry is made:

February 26, 19—

L. K. King	2400.00	
Notes Payable		2400.00
To apply on account 2		
months' note dated 2/26		
with interest at $5\frac{1}{2}\%$.		

On April 26, when the note is due, the following entry expressed in journal form would be made:

April 26

Notes Payable	2400.00	
Interest Expense	22.00	
Cash		2422.00
Note issued to L. K. King		
due to-day with interest		
at $5\frac{1}{2}\%$ for 2 mos.		

The interest is calculated as follows:

Interest on \$2400.00 for 2 months at 6%	24.00
$5\frac{1}{2}\%$ interest is $\frac{1}{12}$ less than 6% interest	
Deduct $\frac{1}{12}$ of interest at 6%	2.00
Interest on \$2400.00 for 2 mos. at $5\frac{1}{2}\%$	<u>22.00</u>

Discounting of Non-Interest-Bearing Negotiable Instruments. One of the functions of a commercial bank is the lending of money on or the buying of negotiable instruments. The holder of the instrument indorses it, hands it over to the bank, and the bank pays him the maturity value of the instrument less the interest on the maturity value, for the period from the date of discount to the maturity of the paper.

The deduction made by a bank for advancing money on negotiable instruments is called *bank discount*. The period between the date on which the instrument is discounted and the date of maturity is called the *term of discount*. The difference between the maturity value and the bank discount is called the *net proceeds*.

Accounting for a Discounted Non-Interest-Bearing Note, Draft, or Trade Acceptance. The bank discount deducted by the bank is actually interest paid in advance. The interest is figured on the maturity value and the one discounting the instrument receives the net proceeds.

The following illustrations are used to explain the accounting for this type of transaction:

Illustration No. 1 — Discounting a Non-Interest-Bearing Note

William Jones holds a non-interest-bearing note receivable signed by Samuel White dated March 10, 19—, due in 60 days, for \$1500.00. On March 31, 19—, William Jones discounts this note at the Marine National Bank at 6%.

The date of maturity is May 9, 19—.

Note: When the time is expressed in days, the exact number of days in each month is used in obtaining the date of maturity.

The term of discount, the time between March 31, 19—, and May 9, 19—, is 39 days.

Interest on the maturity value (\$1500.00) for 39 days:

Interest on \$1500.00 for 60 days		15.00
Interest on 1500.00 for	30 days	7.50
Interest on 1500.00 for	6 days ($\frac{1}{5}$ of 30)	1.50
Interest on 1500.00 for	3 days ($\frac{1}{2}$ of 6)	.75
Interest on 1500.00 for	39 days	9.75

The net proceeds is \$1500.00 minus \$9.75, or \$1490.25.

The entry for this transaction, expressed in journal form, is:

	March 31, 19—	
Cash		1490.25
Interest Expense		9.75
Notes Receivable		1500.00
Discounted note of Samuel White due May 9, 19— at 6%.		

Note: The discount, although it is interest paid in advance, is charged to the Interest Expense account during the period and then at the end of the period an adjustment may be made of any interest which is prepaid.

Illustration No. 2 — Discounting a Two-Party Draft

William Jones holds a draft drawn on and accepted by K. S. Thomas, due May 1, 19—, for \$900.00. On April 10, 19—, he discounts this draft at the Liability Trust Company at 6%.

The term of discount, the time between April 10, 19—, and May 1, 19—, is 21 days.

Interest on the maturity value (\$900.00) for 21 days:

Interest on \$900.00 for 6 days		.90
Interest on \$900.00 for	18 days (3×6)	2.70
Interest on \$900.00 for	3 days ($\frac{1}{2}$ of 6)	.45
Interest on \$900.00 for	21 days	3.15

The net proceeds is \$900.00 minus \$3.15, or \$896.85.

The entry for this transaction, expressed in journal form, is

	April 10, 19—	
Cash		896.85
Interest Expense		3.15
Notes Receivable		900.00
Discounted draft of K. S. Thomas due May 1, 19— at 6%.		

Illustration No. 3 — Discounting a Trade Acceptance

William Jones holds a trade acceptance drawn on and accepted by Alfred Reid due May 15, 19—, for \$1600.00. On March 10, 19—, he discounts this acceptance at the First National Bank at $5\frac{1}{2}\%$.

The term of discount, the time between March 10, 19—, and May 15, 19—, is 66 days.

Interest on the maturity value (\$1600.00) for 66 days:

Interest at 6% on \$1600.00 for 60 days	16.00	
Interest at 6% on \$1600.00 for 6 days	<u>1.60</u>	
Interest at 6% on \$1600.00 for 66 days	17.60	
Less $\frac{1}{12}$ to reduce it to interest at $5\frac{1}{2}\%$	<u>1.47</u>	
Interest at $5\frac{1}{2}\%$ on \$1600.00 for 66 days		16.13

The net proceeds is \$1600.00 minus \$16.13, or \$1583.87.

The entry for this transaction expressed in journal form, is:

	March 10, 19—	
Cash	1583.87	
Interest Expense	16.13	
Acceptances Receivable		1600.00
Discounted acceptance of Alfred Reid due May 15 at $5\frac{1}{2}\%$.		

Accounting for a Discounted Note Payable. Banks usually on loaning money on a person's or firm's own promissory note, deduct the interest at the time the loan is made and remit to the borrower the net proceeds. Thus, if A. R. Dorman takes his promissory note for \$2000.00, dated June 10, 19—, and due in 60 days, to the bank for discount, the bank will deduct the interest for 60 days (\$20.00) from the amount of the note and will give him

the balance (\$1980.00). The entry for this transaction, expressed in journal form, is:

	June 10	
Cash		1980.00
Interest Expense		20.00
Notes Payable		2000.00
Discounted note payable dated June 10, 19—, due in 2 mos. at 6%.		

Discounted Note Paid by Maker before Maturity. If the maker of a note, which has been discounted, decides to pay the note before it is due, he may do so and obtain from the bank a rebate on the discount.

Illustration: A B & Co. discounts a 90-day note for \$1000.00 at the bank 90 days before maturity. The discount at 6% is \$15.00.

The entry on the books of A B & Co. is as follows:

	Date	
Cash		985.00
Interest Expense		15.00
Notes Payable		1000.00
Discounted our 90-day note.		

Sixty days after discounting the above note, A B & Co. decide to pay the note. The bank will rebate to A B & Co. the interest for the unexpired time, 30 days. This amount at 6% is \$5.00.

The following entry would reflect the transaction on the books of A B & Co.

	Date	
Notes Payable		1000.00
Cash		995.00
Interest Expense		5.00
To record prepayment of note 30 days before maturity.		

Accounting for Discounted Interest-Bearing Notes Receivable. The discount on any note is based on the *maturity value* of the note, which, in the case of an interest-bearing note, is the face plus the interest at the specified rate for the term of the note.

Illustration No. 1 — Discounting of an Interest-Bearing Note, the Term of which is Expressed in Months

A. D. Peters holds a note receivable signed by K. L. Watson for \$3000.00, with interest at 6%, dated January 20, 19—, for 3 months. He takes this note on February 10, 19—, to the First National Bank and has it discounted at $5\frac{1}{2}\%$.

The date of maturity is the 20th day of the third month following January, which is April 20, 19—.

The term of discount, the time between February 10, 19—, and April 20, 19—, in the exact number of days, is 69 days.

Interest on the maturity value will be deducted for 69 days at $5\frac{1}{2}\%$.

Face of Note		3000.00
Add — Interest for 3 months at 6%		<u>45.00</u>
Maturity value of Note		3045.00
Discount on \$3045.00 for 60 days at 6%	30.45	
Discount on \$3045.00 for 6 days at 6%	3.05	
Discount on \$3045.00 for 3 days at 6%	<u>1.52</u>	
Discount on \$3045.00 for 69 days at 6%	35.02	
Deduct $\frac{1}{2}\%$ to reduce interest to $5\frac{1}{2}\%$	<u>2.92</u>	
Discount on \$3045.00 for 69 days at $5\frac{1}{2}\%$		<u>32.10</u>
Net proceeds		3012.90

The entry for this transaction, expressed in journal form, is:

	Feb. 10	
Cash	3012.90	
Notes Receivable		3000.00
Interest Income		12.90
Discounted K. L. Watson's		
3 months' 6% note, for \$3000		
at the First Street Bank		
at $5\frac{1}{2}\%$.		

*Illustration No. 2 — Discounting of an Interest-Bearing Note,
the Term of which is Expressed in Days*

A. D. Peters holds a note receivable signed by A. R. Kelly for \$1800.00, with interest at 5%, dated March 1, 19—, for 90 days. He takes his note on March 3, 19—, to the First Street Bank and has it discounted at 6%.

The date of maturity is 90 days after March 1, 19—, which is May 30, 19—. As May 30 is a legal holiday, this note is due May 31.

The term of discount, the time between March 3, 19—, and May 31, 19—, is 89 days.

Face of Note			1800.00
Add — Interest at 5% for 90 days:			
Interest on \$1800.00 for 90 days at 6%	27.00		
Less $\frac{1}{8}$ to reduce to interest at 5%	4.50		22.50
Maturity value of note			1822.50
Discount on \$1822.50 for 60 days at 6%	18.22		
Discount on \$1822.50 for 30 days at 6%	9.11	27.33	
Discount on \$1822.50 for 1 day at 6%		.30	
Discount on \$1822.50 for 89 days at 6%			27.03
Net Proceeds			1795.47

The entry for this transaction, expressed in journal form, is:

March 3.	
Cash	1795.47
Interest Expense	4.53
Notes Receivable	1800.00
Discounted A. R. Kelly's	
90-day 5% note for \$1800.00	
at the First Street Bank	
at 6%.	

Note: It should be noted that the credit to Interest Income in Illustration No. 1 is the excess of the net proceeds over the face value, and the debit to Interest Expense in Illustration No. 2 is the difference between the face value and the net proceeds. The addition of the interest by the bank to the face to obtain the maturity value is only an arithmetical computation performed in arriving at the amount of the discount and should not be recorded on the books as income.

Practices of Banks as to Due Dates. If a negotiable paper is due on a Sunday or holiday, it is payable on the next business day, and the time is extended accordingly. It is customary in some sections to extend the time for payment of a negotiable instrument which becomes due on Saturday until the next business day. In case the following Monday is a holiday, a note falling due on Saturday or Sunday would be payable on Tuesday. In practice the calculation of the term of discount would vary accordingly.

Contingent Liability. As explained previously, an indorser, unless he uses a qualified indorsement, is liable for payment of the instrument if the maker fails to pay at maturity. In other words, he assumes the liability to pay the instrument if the maker fails to pay it.

An obligation, which, depending upon the performance or non-performance by another person of a future act, becomes either no liability or a real liability, is called a *contingent liability*.

Contingent liabilities may be recorded on the books as

they are incurred or they may only be considered at the end of a fiscal period when the statements are being prepared. If discounted notes are few in number, it is satisfactory to consider at the end of the period the contingent liability on the indorsed notes not due and unpaid at that time.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What services are rendered by commercial banks to individuals or firms?
2. Explain the procedure of opening a checking account.
3. How should an individual sign his name in making out a check on a bank?
4. What are the advantages of duplicate deposit slips?
5. Explain how the balance in the bank may be carried along in the check book.
6. In what way does the bank monthly statement answer for the balancing of the pass book?
7. Why is it necessary to reconcile the bank statement balance with the check book balance?
8. Explain the two methods illustrated of reconciliation of the bank account.
9. Explain the difference between ordinary interest and exact interest.
10. Why is there no entry for interest on notes at the time the note is received or issued?
11. Give the entry made when a note receivable bearing interest is paid.
12. Define bank discount, term of discount, net proceeds, face value, maturity value.
13. When are face value and maturity value of a note the same in amount? When do they differ?
14. Explain a contingent liability.

CHAPTER XIII

CONTROLLING ACCOUNTS: FURTHER DEVELOPMENT OF SPECIAL JOURNALS

Subdivision of Ledger. The basic principle underlying the subdivision of the Journal was the grouping of the transactions of the same nature, which occurred frequently, in a special journal created for this purpose. This same principle may be applied to the Ledger by providing special ledgers for the keeping of accounts of the same nature and removing these accounts from the General Ledger.

The accounts receivable and accounts payable, generally in a trading business, constitute the largest percentage of the accounts and are the accounts which are usually kept in separate ledgers. The ledger in which the accounts receivable are kept is called the *Accounts Receivable Ledger*; it is also called the *Sales Ledger* or *Customers' Ledger*. The ledger in which the accounts payable are kept is called the *Accounts Payable Ledger*; it is also called *Purchases Ledger* or *Creditors' Ledger*.

Controlling Accounts. To maintain the equality of debits and credits in the General Ledger and to provide a check on the accuracy of the accounts kept in a special ledger, accounts are set up in a general ledger to take the place of and to control these special ledger accounts.

A General Ledger account which acts as a substitute for the accounts kept in a special record, and which shows a net balance equal to the sum of the balances of these accounts is called a *controlling account*.

The special ledgers which furnish the details of the controlling accounts are called *subsidiary ledgers*.

Thus, for the customers' accounts which are removed from the General Ledger and kept in a subsidiary ledger, the controlling account, Accounts Receivable, is substituted in the General Ledger.

For the creditors' accounts which are removed from the General Ledger and kept in a subsidiary ledger, the controlling account, Accounts Payable, is substituted in the General Ledger.

The fundamental principle underlying the operation of control accounts and subsidiary ledgers is that every debit or credit which is posted to an account in the subsidiary ledger *must* in some way be posted as a debit or credit to the corresponding controlling account.

Operation of the Controlling Accounts, Accounts Receivable and Accounts Payable. The beginning and operation of the controlling accounts, Accounts Receivable and Accounts Payable, is explained through the following illustration:

William Kent has been keeping but one ledger, the General Ledger, from which the following trial balance is taken on June 30, 193—.

WILLIAM KENT

TRIAL BALANCE, JUNE 30, 193—

1	Cash	4,270.50	
1	Notes Receivable	4,800.00	
1	Acceptances Receivable	2,400.00	
2	A. L. Allen	860.60	
2	K. R. Boyce	470.20	
3	N. O. Dolan	910.80	
3	Ed. A. Francis	1,670.40	
3	E. J. Goode	830.50	
4	H. H. Hall	166.70	
4	D. K. Robbins	930.40	
5	H. K. Thomas	1,005.60	
5	Thomas Wray	60.70	
6	Merchandise Inventory Jan. 1, 193—	6,870.65	
6	Furniture and Fixtures	2,840.00	
6	Office Appliances	1,600.00	
7	Notes Payable		3,000.00
8	D. K. Borden Co.		3,670.00
8	F. D. Sayles & Co.		2,420.00
9	M. N. Mason		3,310.00
10	D. D. Goff		2,460.00
10	M. R. Block		730.00
11	William Kent — Drawing	2,450.00	
11	William Kent — Capital		10,871.85
12	Sales		58,764.00
12	Sales Returns and Allowances	240.60	
13	Purchases	38,860.70	
13	Freight, Express and Cartage in	310.50	
13	Purchases Returns and Allowances		340.00
14	Salaries	6,550.00	
14	Rent	3,600.00	
14	Stationery and Supplies	210.00	
14	Telephone and Telegraph	120.00	
15	Insurance	300.00	
15	Traveling Expense	1,670.00	
16	Advertising	820.00	
16	General Expense	467.00	
16	Interest Income		110.60
17	Discount on Purchases		640.00
17	Interest Expense	220.00	
17	Discount on Sales	810.60	
		86,316.45	86,316.45

He decides on July 1, 193—, to remove the customers' and creditors' accounts from the General Ledger and to keep them in subsidiary Accounts Receivable and Accounts Payable Ledgers. In place of the accounts so removed from the General Ledger, the controlling accounts, Accounts Receivable and Accounts Payable, will be substituted.

The following entries are made to close the customers' and creditors' accounts and to open the controlling accounts in the General Ledger:

JULY 1, 193—

1	Accounts Receivable	6,905.90	
2	A. L. Allen		860.60
2	K. R. Boyce		470.20
3	N. O. Dolan		910.80
3	Ed. A. Francis		1,670.40
3	E. J. Goode		830.50
4	H. H. Hall		166.70
4	D. K. Robbins		930.40
5	H. K. Thomas		1,005.60
5	Thomas Wray		60.70
	To open the controlling account, Accounts Receivable, and to close the customers' accounts.		
			
8	D. K. Borden Co.	3,670.00	
8	F. D. Sayles & Co.	2,420.00	
9	M. N. Mason	3,310.00	
10	D. D. Goff	2,460.00	
10	M. R. Block	730.00	
8	Accounts Payable		12,590.00
	To close the creditors' accounts and open the controlling account, Accounts Payable.		

The balances of the customers' accounts are transferred directly to new accounts in the Accounts Receivable Ledger

and the balances of the creditors' accounts are transferred to the Accounts Payable Ledger. After opening the accounts in the subsidiary ledgers the sum of the balances of the individual accounts in each ledger should be obtained and compared with the balance of the controlling accounts.

Loose-Leaf Ledgers. In practice where loose-leaf ledgers are used, the ledger accounts themselves may be removed from the General Ledger and put in a separate binder. A loose-leaf sheet for the controlling account may then be placed in the General Ledger and the controlling account opened thereon. It would then be necessary to post only the amount of the controlling accounts from the journal entry. The individual amounts of the balances of the subsidiary accounts would not in this instance be posted, as the accounts are to be continued on the same sheets as before.

Effect of Controlling Accounts on General Ledger Trial Balance. The trial balance of the General Ledger of William Kent, after removing the accounts to a subsidiary ledger and substituting the controlling accounts, is shown on page 205. Notice that instead of 40 account names, as in the first trial balance, there are now 27 account titles.

Usually the customers' accounts, and creditors' accounts are very numerous. No matter how many accounts there may be in the subsidiary ledgers, only one account appears in the General Ledger for each subsidiary ledger.

WILLIAM KENT

TRIAL BALANCE, JUNE 30, 193—

Cash	4,270.50	
Notes Receivable	4,800.00	
Acceptances Receivable	2,400.00	
Accounts Receivable (Control)	6,905.90	
Merchandise Inventory Jan. 1, 193—	6,870.65	
Furniture and Fixtures	2,840.00	
Office Appliances	1,600.00	
Notes Payable		3,000.00
Accounts Payable (Control)		12,590.00
William Kent, Drawing	2,450.00	
William Kent, Capital		10,871.85
Sales		58,764.00
Sales Returns and Allowances	240.60	
Purchases	38,860.70	
Freight in	310.50	
Purchases Returns and Allowances		340.00
Salaries	6,550.00	
Rent	3,600.00	
Stationery and Supplies	210.00	
Telephone and Telegraph	120.00	
Insurance	300.00	
Traveling Expense	1,670.00	
Advertising	820.00	
General Expense	467.00	
Interest Income		110.60
Discount on Purchases		640.00
Interest Expense	220.00	
Discount on Sales	810.60	
	<u>86,316.45</u>	<u>86,316.45</u>

Posting to the Controlling Account. The controlling account takes the place in the General Ledger of the accounts which it controls. Consequently, every debit and credit to the accounts in the subsidiary ledgers must be posted to the controlling account in some way in order that

the balance of the controlling account, after all postings are made, will equal the sum of the balances of the accounts in the subsidiary ledger.

Provision is made in all the journals from which individual postings are made to the subsidiary ledgers, for the accumulation of the individual debits and credits for posting in total to the controlling accounts.

The Purchases and Sales Journals contain entries for only one kind of transaction; therefore, the only provision needed to take care of the controlling account is to make an entry at the end of the month for the total in each journal.

The Cash Receipts Journal contains receipts of cash from customers (accounts receivable), from proprietor's investment, from payment of notes, interest, and other sources. Cash payments are made to creditors (accounts payable), for expenses, to proprietor for drawings, etc. The General Journal contains all miscellaneous transactions which do not go in a special journal. Some of these transactions affect the controlling accounts, and some do not. It is necessary, therefore, to provide special columns in these journals to take care of the controlling account postings.

The operation of controlling accounts and subsidiary ledgers is explained through the following illustration based on the transactions of William Kent for the month of July, 193—:

The transactions which are entered in the Sales Book and the Purchases Book are evident from the entries in these books. The transactions entered in the Cash Book and Journal accompany the entries to facilitate the tracing of them in these books.

SALES BOOK

MERCHANDISE SALES FOR MONTH OF JULY, 193—

Day	Account Dr.	Address	Terms	F	Amount Sales Cr.	Total
1	Thos. Wray	Providence, R.I.	2/10 n/30	5	260 00	
5	D. K. Robbins	Hartford, Conn.	30-day accept.	4	310 50	
6	H. K. Thomas	Worcester, Mass.	2/10 n/30	5	189 50	
8	A. L. Allen	Springfield	2/10 n/30	2	360 50	
9	H. H. Hall	Lynn, Mass.	20-day note with int. 6%	4	1600 00	
11	K. R. Boyce	Albany, N.Y.	2/10 n/30	2	260 50	
13	N. O. Dolan	New Haven, Conn.	20-day note with int. 6%	3	900 00	
15	Ed. A. Francis	Rutland, Vt.	2/10 n/30	3	510 65	
15	E. J. Goode	Jamaica, Mass.	2/10 n/30	3	165 70	
16	Cash Sales		Cash	*5	300 50	
18	D. K. Robbins	Hartford, Conn.	30-day accept.	4	400 60	
22	A. L. Allen	Springfield	2/10 n/30	2	100 00	
26	H. H. Hall	Lynn, Mass.	60-day note with int. 6%	4	1000 00	
30	E. J. Goode	Jamaica, Mass.	2/10 n/30	3	300 00	
30	Accounts Receivable Dr.			1 }		6658 45
	Sales Cr.			12 }		

* In this exercise sales for cash are treated just as a sale on account and an account Cash Sales is opened in the Accounts Receivable Ledger to which the sale recorded in the Sales Book is debited.

Posting the Sales Book. The amount of each individual sale is posted to the account of the customer in the subsidiary Accounts Receivable Ledger. At the end of the month the total of the sales is posted to the debit of the controlling account, Accounts Receivable, in the General Ledger and this total is also posted as a credit to the Sales account.

The total posted at the end of the month to the debit of the Accounts Receivable account is equal to the sum of all the individual debits posted during the month to the customers' accounts in the subsidiary ledger.

PURCHASE BOOK

MERCHANDISE PURCHASES FOR THE MONTH OF JULY, 193—

Day	Account Cr.	Address	Terms	F	Amount Pur. Dr.	Total
5	M. R. Black		3/5 n/60	10	3160 00	
9	D. K. Borden Co.		2/10 n/30	8	890 70	
12	M. N. Mason		On acct.	9	220 40	
18	D. D. Goff		60-day trade			
			acceptance	10	860 50	
24	F. D. Sayles & Co.		30-day note			
			with int.	8	764 70	
*26	Cash Purchases			11	114 60	
30	M. N. Mason		2/10 n/30	9	1160 70	
30	Purchases Dr.			13		
	Accounts Payable Cr.			7 }		7171 60

* Cash purchases are entered in the Purchases Book just as if they were a purchase from a creditor by the name of Cash Purchases. An account is kept in the Accounts Payable Ledger for Cash Purchases and such purchases are posted to the credit of this account.

Posting the Purchase Book. The amount of each individual purchase is posted to the credit of the creditor's account in the subsidiary Accounts Payable Ledger. At the end of the month the total of the purchases is posted as a debit to Purchases account and as a credit to the controlling account, Accounts Payable. This credit to the controlling account is equal to the sum of the individual credits posted to the creditors' accounts in the subsidiary ledger.

Columnar Development of Cash Book — Receipt Side. In order to provide for the posting of the payments made by customers to the credit of the controlling account, Accounts Receivable, a special column is added to the receipts side of the Cash Book called the Accounts Receivable column. The amounts to be credited to the customers' accounts for payments made are entered in this column. A column is also added to provide for the recording of discounts allowed to customers, thus eliminating the necessity

of making a separate entry in the General Journal for each discount allowed to a customer. The addition of these two columns necessitates the use of a column to record the net amount of cash received, the Cash Dr. column, and a column to record the amounts that are to be credited to the accounts in the General Ledger, the General Ledger Cr. column.

It should be observed that the General Ledger and Accounts Receivable columns are credit columns and that the Discount on Sales and Cash columns are debit columns. The sum of the debit columns must always equal the sum of the credit columns.

Posting of the Receipt Side of the Cash Book. The net amount of cash received is entered in the Cash Dr. column. The total of this column is posted at the end of the month to the debit of Cash account in the General Ledger.

The amount of discount allowed to customers is entered in the Discount on Sales column. Discounts allowed on General Ledger items may also be recorded in this column, but marked with an asterisk or some other sign to indicate they are not discount on sales. The amounts entered in the Discount on Sales column are *not* posted individually but the total at the end of the month is analyzed and the result of the analysis posted to the debit of the General Ledger accounts, Discount on Sales, and Interest Expense as the case may be.

In the next column, the Accounts Receivable column, the amount of *credit to which a customer is entitled* is entered. The amounts entered in this column are posted individually to the credit of the customers' accounts in the subsidiary ledger. At the end of the month the total of this column is posted to the credit of the controlling account, Accounts

Receivable, in the General Ledger. This total, posted to the credit of the controlling account, is equal to the sum of individual credits to the customers' accounts in the subsidiary ledger.

The amounts to be posted to the credit of accounts in the General Ledger are entered in the General Ledger Cr. column. These amounts are posted individually to the credit of the account written in the Account Cr. column. Inasmuch as the amounts in the General Ledger Cr. column are posted individually to the credit of the individual accounts the total of this column at the end of the month *is not* posted.

Columnar Development of Cash Book — Payment Side.

In order to provide for the posting of the payments made to creditors, to the debit of the controlling account, Accounts Payable, a special column is added to the payment side of the Cash Book called Accounts Payable Dr. column. The amounts to be debited to the creditors' accounts for cash payments are entered in this column. A column is also added to provide for the recording of the discounts allowed by the creditors, thus eliminating the necessity of making separate General Journal entries for such discounts.

The addition of the above-named columns necessitates a column for the amounts which are to be posted to the debit of General Ledger accounts, the General Ledger Dr. column, and a column for the net cash paid, the Cash Cr. column.

The General Ledger and Accounts Payable columns are debit columns and the Discount on Purchases and Cash columns are credit columns. The sum of the debit columns must at all times be equal to the sum of the credit columns.

Posting of the Cash Payments Journal. The net amount of cash paid is entered in the Cash Cr. column. The total

of this column is posted, at the end of the month, to the credit of the Cash account.

The discount allowed by the creditor is entered in the Discount on Purchases column. The total of this column, at the end of the month, is posted to the credit of the General Ledger account, Discount on Purchases.

In the Accounts Payable Dr. column, the amount to be debited to the creditor for payments made on account is recorded. The amounts entered in this column are posted individually to the debit of the creditors' accounts in the subsidiary ledger. At the end of the month, the total of this column is posted to the debit of the controlling account, Accounts Payable, in the General Ledger. This posting in total to the debit of the controlling account is equal to the sum of the individual postings to the debit of the creditors' accounts in the subsidiary ledger.

The amounts to be posted to the debit of accounts in the General Ledger are placed in the General Ledger Dr. column and are posted individually to the debit of the General Ledger account written in the Account Dr. column. The total of this column *is not* posted at the end of the month.

CASH RECEIPTS TRANSACTIONS

July 8, 193— Receive cash \$1000 from Ed. A. Francis to apply on account.

- 9 Receive cash \$985.49 from H. K. Thomas in full payment for balance due July 1, 193—. Amount due July 1, 193—, \$1005.60. Discount \$20.11.
- 10 Discounted a note payable due in 60 days at the Lincoln Trust Co. for \$4000. Discount at 6% for 60 days \$40.
- 10 Receive cash \$60.70 from Thos. Wray in payment for balance of account due on July 1.
- 10 Receive cash \$2448. from H. H. Hall in part payment of note received from him on May 11, and interest on the full note. Payment on note of \$2400, interest \$48.00.
- 10 Received cash \$254.80 from Thos. Wray in full payment of invoice of July 1, 193—. Amount of invoice \$260, discount \$5.20.
- 12 Discounted D. K. Robbins trade acceptance due Aug. 5, 193— for \$310.50 at the Union Trust Co. Discount at 6% \$1.24.
- 16 Receive cash \$300.50 for cash sales.
- 17 Receive cash \$166.60 from H. K. Thomas in payment for invoice of July 6, 193—. Amount of invoice less return goods \$170, discount \$3.40.
- 18 Receive cash \$353.29 from A. L. Allen in full payment of invoice of July 8, 193—. Amount of invoice \$360.50, discount \$7.21.
- 20 Discounted H. H. Hall's note due July 30, 193— for \$1600 with interest at 6% at the Union Trust Co. Discount at 6%. Net proceeds \$1602.65.
- 22 Receive cash \$255.29 from K. R. Boyce in full payment for sale of July 11, 193—. Amount of invoice \$260.50, discount \$5.21.

CASH PAYMENTS TRANSACTIONS

- July 2, 193— Paid cash \$730 to M. R. Block in full payment for balance due July 1, 193—.
- 6 Paid cash \$11.60 for telephone and telegraph.
- 8 Paid cash \$3559.90 to D. R. Borden in full payment for balance due on July 1, 193—. Balance due July 1, \$3670. Discount at 3%, \$110.10.
- 10 Paid cash \$2813 to M. R. Block in full payment of amount due on invoice of July 5, 193—. Amount of invoice less return \$2900, discount \$87.
- 12 Paid cash \$2000 to M. N. Mason to apply on account.
- 15 Paid cash \$600 for rent for month.
- 16 Issued a check for \$100 for the establishment of a petty cash fund.
- 19 Paid cash \$872.89 to D. K. Borden Co. in full payment for invoice of July 9, 193—. Amount of invoice \$890.70, discount \$17.81.
- 24 Paid cash \$1515 for our note for \$1500 and interest for 2 months, \$15. This note was given to D. D. Goff on May 24, 193—.
- 26 Paid cash \$114.60 for a cash purchase.
- 28 Paid cash \$270 for freight and cartage.
- 31 Paid cash \$380 for traveling expenses.
- 31 Paid cash \$1050 for salaries of employees for one month.

CASH BOOK

CASH RECEIVED FOR THE MONTH OF JULY, 193—

Date	Name of Acct Credit	Explanation	F	Cash Dr.	Discount on Sales Dr.	Accts Rec. Cr.	Gen'l Ledger Cr.
1	Balance Br't for'd	\$6270.50					
8	Ed. A. Frances	On a/c	3	1000 00		1000 00	
9	H. K. Thomas	7/1 less 2% Discount	5	985 49	20 11	1005 60	
10	Notes Payable	60-day note	7	3960 00	*40 00		4000 00
10	Thomas Wray	Bal. to 7/1 On a/c note	5	60 70		60 70	
10	Notes Receivable	H. H. Hall	J.	2400 00			2400 00
10	Interest Income	Int. above	16	48 00			48 00
10	Thos. Wray	Inv. 7/1 less 2%	5	254 80	5 20	260 00	
12	Accept. Receivable	Disc't D. K. Robbins 6%	1	309 26	*1 24		310 50
16	Cash Sales	Per slips	5	300 50		300 50	
17	H. K. Thomas	7/6 less 2%	5	166 60	3 40	170 00	
18	A. L. Allen	7/8 less 2% Disc't H. H.	2	353 29	7 21	360 50	
20	Notes Receivable	Hall's note	1	1600 00			1600 00
20	Interest Income	On above	16	2 65			2 65
22	K. R. Boyce	7/11 less 2%	2	255 29	5 21	260 50	
				11696 58	82 37	3417 80	8361 15
	<i>Summary for Posting</i>						
	Cash Dr.		1	11696 58			
	Int. Expense Dr.	41.24	17				
	Discount on Sales Dr.	41.18	17	82 37			
	Accounts Rec. Cr.		1		3417 80		
	General Ledger Cr.		✓		8361 15		
				11778 95	11778 95		

* In order to avoid making a Journal entry for the bank discount deducted by the bank on the note payable discounted on July 7 and on the trade acceptance discounted on July 12, the discounts are entered in the Discount on Sales column and an asterisk placed beside them. At the end of the month this column is analyzed as illustrated on the model, and the discount deducted by the bank is posted to the Interest Expense account, and the remainder of the amounts in this column is posted to Discount on Sales. The special columns in the Cash Journal may be arranged in any order desired, either as shown in the model or reversed.

CASH BOOK

CASH PAID FOR THE MONTH OF JULY, 193—

Date	Name of Acc't Debit	Explanation	F	Cash Cr.	Discount on Pur. Cr	Acc'ts Pay. Dr.	Gen'l Ledger Dr.
2	M. R. Block	In full	10	730 00		730 00	
6	Tel. & Telegraph	Service	15	11 60			11 60
8	D. R. Borden	Inv. 7/1 less 3%	8	3559 90	110 10	3670 00	
10	M. R. Block	Inv. 7/5 less dis't	10	2813 00	87 00	2900 00	
12	M. M. Mason	On a/c	9	2000 00		2000 00	
15	Rent	For month	14	600 00			600 00
16	Petty Cash	To est. fund	1	100 00			100 00
19	D. K. Borden Co.	Inv. 7/9 less dis't	8	872 89	17 81	890 70	
24	Notes Payable	Note of 5/24 to Goff.	7	1500 00			1500 00
24	Int. Expense	Int. on above	17	15 00			15 00
26	Cash Purchases	Inv. of Moore	11	114 60		114 60	
28	Frt. Exp. & Cart.	Bills to date	13	270 00			270 00
31	Traveling Exp.	For month	15	380 00			380 00
31	Salaries	For month	14	1050 00			1050 00
				14016 99	214 91	10305 30	3926 60
	<i>Summary for Posting</i>						
	Acct's Payable Dr.		13	10305 30			
	General Ledger Dr.		✓	3926 60			
	Cash Cr.		1		14016 99		
	Disc't on Purchases Cr.		17		214 91		
				14231 90	14231 90		

Development of the General Journal. In order to provide for the posting in total to the controlling accounts of the debits and credits which are posted to the subsidiary ledgers, special columns have been added to the General Journal named Accounts Receivable and Accounts Payable columns. The columns to the left of the wide space in the middle of the page are debit columns and the columns to the right are credit columns.

Debit Side. The amounts to be debited to creditors are entered in the Accounts Payable column and are posted from this column to the debit of the creditors' accounts in the Accounts Payable Ledger. The total of this column at the end of the month is posted to the debit of the Accounts Payable controlling account.

The amounts which are to be posted to the debit of the General Ledger accounts are entered in the General Ledger Dr. column. They are posted individually from this column to the debit of the proper General Ledger account. The total of this column is not posted at the end of the month as each entry is posted individually.

Credit Side. The amounts which are to be posted to the credit of the General Ledger accounts are entered in the General Ledger Cr. column. They are posted individually from this column to the credit side of the proper General Ledger account. The total of this column is not posted at the end of the month, as each entry is posted individually.

The amounts which are to be posted to the credit of the customers' accounts are entered in the Accounts Receivable Cr. column and are posted from this column to the credit of the customers' accounts in the Accounts Receivable Ledger. The total of this column at the end of the month

is posted to the credit of the Accounts Receivable controlling account.

Where no special column is provided for any entry, it is recorded in the General Ledger column. Whenever additional columns are desired, they may be added by extending the size of the paper used. The entries which would be recorded in these additional columns would normally be recorded in the General columns.

July 8, 193— H. K. Thomas returns merchandise billed to him on July 6, 193— for \$19.50.

- 8 Received trade acceptance due August 5, 193—, from D. K. Robbins for \$310.50 in payment for invoice of July 5, 193—.
- 8 Returned merchandise to M. R. Block billed to us on July 5, 193— at \$260.
- 10 Receive a note receivable due August 9, 193—, from H. H. Hall for \$2400 with interest at 6% in renewal of one half of note maturing to-day for 30 days.
- 10 Receive a note receivable due July 30, 193—, from H. H. Hall for \$1600 with interest at 6% in payment for invoice of July 13, 193—.
- 15 Receive a note receivable due August 5, 193—, from N. O. Dolan for \$900 with interest at 6% in payment for invoice of July 13, 193—.
- 20 Accepted the 60-day trade acceptance drawn by D. D. Goff for \$860.50 in payment for invoice of July 18, 193— and returned it to him.
- 23 Receive a trade acceptance due August 21, 193—, from D. K. Robbins, properly accepted, for \$400.60 in payment for invoice of July 18, 193—.
- 26 Issued a note payable to F. D. Sayles & Co. due in 30 days with interest at 6% in payment for invoice of July 24, 193—.
- 31 Receive a note receivable due Sept. 26, 193—, from H. H. Hall for \$1000 in payment for invoice of July 26, 193—.

JULY 8, 193—

Acc'ts Pay. Dr.	General Ledger Dr.	F		General Ledger Cr.	Acc'ts Rec. Cr.
	19 50	12	Sales Ret. & Allowances		
		5	H. K. Thomas		19 50
			Ret. mdse of 7/6/3— 8		
	310 50	1	Accept. Receivable		
		4	D. K. Robbins		310 50
			Due 8/5/3— 8		
260 00		10	M. R. Block		
		13	Pur. Ret. & Allowances	260 00	
			Ret. mdse of 7/5/3— 10		
	2400 00	✓	Cash		
	2400 00	1	Notes Receivable		
		1	Notes Receivable	4800 00	
			Renewal of $\frac{1}{2}$ note due to-day. See C. B. 1 10		
	1600 00	1	Notes Receivable		
		4	H. H. Hall		1600 00
			Note with int. due 8/6/3— 15		
	900 00	1	Notes Receivable		
		3	N. O. Dolan		900 00
			Note with int. due 8/5/3— 20		
860 50		10	D. D. Goff		
		7	Accept. Payable	860 50	
			Due in 60 days for invoice of 7/18/3— 23		
	400 60	1	Accept. Receivable		
		4	D. K. Robbins		400 60
			Due 8/21/3— for inv. of 7/18/3—		
1120 50	8030 60		Forwarded	5920 50	3230 60

JULY 26, 193—

Acc'ts Pay. Dr.		General Ledger Dr.		F		General Ledger Cr.		Acc'ts Rec. Cr.	
1120	50	8030	60		Brot forward	5920	50	3230	60
764	70			8	F. D. Sayles & Co.				
				7	Notes Payable	764	70		
					Due in 30 days with				
					int. 6% for Inv. 7/24/3—				
					31				
		1000	00	1	Notes Receivable			1000	00
					H. H. Hall				
					Due 9/26/3— for Inv.				
					of 7/26/3— with int. 6%				
					31				
1885	20	9030	60			6685	20	4230	60
					<i>Summary for Posting</i>				
		1885	20	7	Acc'ts Payable				
		9030	60	✓	General Ledger Dr.				
				✓	General Ledger Cr.	6685	20		
				1	Acc'ts Receivable	4230	60		
		10915	80			10915	80		

The following trial balance and schedules of controlling accounts were prepared from the entries in the Model Journals of this chapter.

WILLIAM KENT

TRIAL BALANCE, JULY 31, 193—

Cash	3,950.09	
Petty Cash	66.50	
Notes Receivable	4,300.00	
Acceptances Receivable	2,800.60	
Accounts Receivable (Control)	5,915.95	
Merchandise Inventory	6,870.65	
Furniture and Furnishings	2,840.00	
Office Appliances	1,600.00	
Acceptances Payable		860.50
Notes Payable		6,264.70
Accounts Payable (Control)		7,571.10
William Kent — Drawing	2,450.00	
William Kent — Capital		10,871.85
Sales		65,422.45
Sales Returns and Allowances	260.10	
Purchases	44,032.30	
Freight, Express and Cartage in	593.30	
Purchases Returns and Allowances		600.00
Salaries	7,600.00	
Rent	4,200.00	
Stationery and Supplies	217.10	
Telephone and Telegrams	135.30	
Insurance	300.00	
Traveling Expense	2,056.30	
Advertising	820.00	
General Expense	470.60	
Interest Income		161.25
Discount on Purchases		854.91
Interest Expense	276.24	
Discount on Sales	851.73	
	<u>92,606.76</u>	<u>92,606.76</u>

WILLIAM KENT

SCHEDULE OF ACCOUNTS RECEIVABLE

JULY 31, 193—

A. L. Allen	960.60	
K. R. Boyce	470.20	
N. O. Dolan	910.80	
E. A. Francis	1,181.05	
E. J. Goode	1,296.20	
H. H. Hall	166.70	
D. K. Robbins	<u>930.40</u>	<u>\$5,915.95</u>

WILLIAM KENT

SCHEDULE OF ACCOUNTS PAYABLE

JULY 31, 193—

F. D. Sayles & Co.	2,420.00	
M. N. Mason	2,691.10	
D. D. Goff	<u>2,460.00</u>	<u>\$7,571.10</u>

The totals of these schedules should agree with the balances of the controlling accounts as shown by the trial balance.

Controlling Accounts' Effect on Bookkeeping Plan. Controlling accounts enable a General Ledger bookkeeper or comptroller to control the work of assistants. One person may handle the Customers' Ledger, recording all sales, and postings to Customers' accounts, and another may handle the Accounts Payable Ledger in the same manner. This allows a subdivision of the office labor and at the same time provides a check on the work of these assistants.

Controlling accounts make it possible to have less bulky General Ledgers and shorter trial balances. The chart of accounts of the business can easily be shown on one standard sized sheet of paper and a better picture of the general account classification is obtained.

It is necessary in the Journals to provide special columns for entries affecting the control accounts and to carefully journalize all transactions which affect these accounts.

Posting Problems. The postings from the journals as now developed differs from the previous custom. There are two different postings to be considered — that is, general ledger posting and subsidiary ledger posting. Subsidiary ledger posting is kept up-to-date by daily posting. Items in the controlling account columns of all journals are posted to the individual accounts daily.

The general ledger posting is largely done at the end of the period, usually a month, when the totals of all special columns are posted to the proper accounts. General ledger columns in all journals may be posted daily or all general ledger posting may be done at the end of the monthly period.

After all postings have been made at the end of a period, a list of the balances of accounts in each subsidiary ledger is prepared and compared with the balance of the corresponding controlling account in the General Ledger. These lists are commonly called schedules and may be numbered or lettered as desired.

MATERIAL FOR CLASS DISCUSSION AND DEMONSTRATION

1. How is the principle of subdivision of the journal applied to the ledger?
2. What is a controlling account?
3. Explain the effect of introducing controlling accounts on the General Ledger.
4. What is the effect on the trial balance?

5. What is the effect of introducing controlling accounts on the form of the special and general journals?
6. Explain how the duplicate posting which is caused by the introduction of controlling accounts is simplified.
7. Explain the posting of a Sales Journal where controlling accounts are used.
8. Explain in detail the posting of the Cash Received Journal.
9. Explain in detail the posting of the Cash Payments Journal.
10. Explain in detail the posting of the General Journal.
11. Explain the difference between the plan of posting the journals when *no* controlling accounts are used and where controlling accounts are used.
12. How is the balance of a controlling account proved?

CHAPTER XIV

OTHER SPECIAL JOURNALS

Accounting for Cash. In accounting for cash — that is, metal and paper money, checks, money orders, sight drafts, etc. — the greatest care should be taken that all cash received is properly recorded and that all cash paid out is properly disbursed. Money received is usually deposited in a bank and is subject to withdrawal by the business on demand. Many businesses make a practice of depositing daily all the cash received during the day and of paying bills by check. The total of the deposits in the bank for a period should then agree with the total of the receipts recorded in the Cash Book, and the total of the checks would agree with the total of the payments recorded in the Cash Book. This makes it possible to check the accuracy of the cash record with the bank record.

Payments which are Generally Made in Money. In every business there are a certain number of payments which are customarily made in money. For example, a purchase of postage stamps, a payment for express or parcel post, car fares, etc., are usually made in money. The money used to make these payments may be taken from the cash received or from a special fund set aside for this purpose.

Disbursements Made from Receipts. When payments of money are made from the current receipts, the money is usually taken out of the cash drawer or register and a memorandum made of the amount paid and the reason for the payment. The total of the cash received each day will

be the sum of the cash left in the drawer plus the amount paid out during the day. The amount deposited in the bank would be the remainder of the receipts after the payments had been deducted.

This method, while it seems simple, results in much confusion and is open to serious objections. Very frequently in attempting to balance the cash — that is, to prove the balance on hand plus the disbursements for the day is equal to the total receipts — difficulty is encountered, due to the omission of a record of some of the payments. Inasmuch as the making of such payment is not delegated to any one person, it encourages laxity in the handling of cash, thus violating the essential business principle that responsibility should be fixed on some one person. Many bills, which might better be paid by check, are paid in money simply because the money is available.

Petty Cash Fund. To provide money for payments which must be paid in money, a certain amount of cash may be set aside from which all such payments are to be made. The amount of this fund is based on an estimate of the requirements for a given period, as indicated by past experience. The amount of each check drawn for this purpose is debited to an account called *Petty Cash*.

Petty Cash Disbursements. For each payment of currency, a voucher should be filled out and signed by the person receiving the money. These vouchers are entered and distributed in a book called the *Petty Cash Book*. A form of voucher for petty cash is illustrated on page 226.

The Petty Cash Book illustrated on page 227 is used as a book of original entry. The totals of the amounts paid out are entered in the Petty Cash Cr. column and this column is posted in total at the end of the month to the

PETTY CASH VOUCHER	
	No. _____
	Date _____ 19____
Received of _____ \$ _____	
Account Charged	Amount
_____	_____
_____	_____
_____	_____
Approved by _____	Entered _____
Signature _____	

credit of the Petty Cash account in the General Ledger. The totals of the Telephone and Telegrams Dr., Stationery and Supplies Dr., and Traveling Expenses Dr. columns are posted at the end of the month to the debit of these accounts in the General Ledger. The debits for sundry payments of currency are indicated in the Sundry Account Dr. column, and these items are posted individually to the General Ledger accounts. The total of this column is not posted.

Transactions for the Petty Cash Record.

- July 18 Paid from petty cash for cleaning of office \$3.60
- 20 Paid from petty cash for postage \$5.00
- 23 Paid from petty cash for train ticket \$2.90
- 24 Paid from petty cash for express \$12.80
- 27 Paid from petty cash for telegram \$1.60
- 29 Paid from petty cash for office supplies \$2.10
- 30 Paid from petty cash for train ticket \$3.40
- 31 Paid from petty cash for telegrams \$2.10

 PETTY CASH RECORD FOR THE MONTH OF JULY, 193—

Day	Explan- ation	Petty Cash Cr.	Tel. & Tel. Dr.	Stat'y & Supp's Dr.	Trav'g Exp. Dr.	F.	Sundry Acc'ts Dr.	Amt.
18	Voucher 1	3 60				16	Gen. Exp.	3 60
20	" 2	5 00		5 00				
23	" 3	2 90			2 90			
24	" 4	12 80				13	Fr't. Exp. & Cart.	12 80
27	" 5	1 60	1 60					
29	" 6	2 10		2 10				
30	" 7	3 40			3 40			
31	" 8	2 10	2 10					
		33 50	3 70	7 10	6 30			16 40
		(1)	(14)	(14)	(15)			(✓)

I O U's. At times proprietors and executives will draw funds from the petty cash and employees will obtain advances on the payroll. Slips properly signed for such payments are left in the cash drawer and not entered in the cash or petty cash record. When the payroll is made up, the amount of the I O U's is deducted from the amount due the employee and the money returned to the cash drawer or petty cash fund. Care should be taken that the money is lent or advanced to employees or others only on the written approval of the proper official.

Purchase and Sales Returns and Allowances. In case goods are returned to a creditor by the business or an allowance is made on the purchase price, an entry may be made in the General Journal the reverse of the original Purchase Book entry, as follows:

Debit — Accounts Payable. (Name of creditor.)

Credit — Purchase Returns and Allowances.

In case of a cash refund from the creditor, an entry would be made in the Cash Receipts Journal, as follows:

Debit — Cash.

Credit — Purchase Returns and Allowances.

In case goods are returned by a customer or an allowance is made on the sales price because of damages to merchandise or quality not up to sample, an entry may be made in the General Journal, as follows:

Debit — Sales Returns and Allowances.

Credit — Accounts Receivable. (Name of customer.)

In case a cash sale is returned and cash refunded, an entry is made in the Cash Payments Journal, as follows:

Debit — Sales Returns and Allowances.

Credit — Cash.

If the above transactions happen frequently, a special journal may be introduced to record each of the above classes of transactions. This would relieve the General Journal of all such entries and allow postings to be made in total. The Purchase Returns Journal would appear exactly the same in form as the Purchases Book, but when posting the summary entries would be made the reverse of those in the Purchases Journal.

A form of Purchase Returns Journal follows:

PURCHASE RETURNS AND ALLOWANCES						
Date	F	Name	Address	Accts Pay.		Pur. Ret. & Allow.
				Dr.		Cr.

The Sales Returns Journal would appear exactly the same in form as the Sales Journal, but when posting the summary, entries would be made the reverse of the Sales Journal entries, as shown above.

A form of Sales Returns Journal follows:

SALES RETURNS AND ALLOWANCES

Date	F	Name	Address	Accts Rec.		Sales Ret. & Allow.	
				Cr.		Dr.	

These journals, when used, are special journals and postings are made direct from them to the General Ledger and subsidiary ledger accounts.

Note Journal. This journal may be used as an original book of entry and as a posting medium, or merely as a supplementary record for informational purposes. In case this journal is used as a posting medium, the Notes Receivable and Notes Payable accounts in the General Ledger may be operated as controlling accounts, and special columns provided in the proper journals for labor-saving in posting. Each entry in the Note Journal occupies one line and space is provided for recording the disposition of the note. This entry along one line represents the account in detail with each note. A separate record is usually kept with Notes and Drafts Receivable and with Notes and Drafts Payable.

Posting of the Notes Receivable Register. This journal may be used as a posting medium or as a subsidiary detail of the Notes Receivable account in the General Ledger. When used as a posting medium, no entry is made in the General Journal for the notes received. At the end of the period the total of the amount column is posted to the debit of the Notes Receivable account and to the credit of the Accounts Receivable account in the General Ledger. The amount of each note should be credited to each individual customer's account in the subsidiary ledger at the time the note is entered.

In case the Note Journal is used as a detail record of the notes received, an entry should be made as usual in the General Journal, in addition to the entry in the Notes Receivable Register, debiting Notes Receivable and crediting the customer and recording in the controlling account, Accounts Receivable, column for posting at the end of the period.

Posting of the Notes Payable Register. This journal may be used as a posting medium or as a subsidiary detail of the Notes Payable account in the General Ledger.

When used as a posting medium no entry is made in the General Journal for the notes payable issued. At the end of the period the total of the amount column is posted to the debit of the Accounts Payable account and to the credit of the Notes Payable account in the General Ledger.

The amount of each note issued is debited to the individual creditor's account in the subsidiary ledger at the time the note is entered.

In case the Note Journal is used as a detail record of the notes payable issued, an entry would be made as usual in the General Journal, in addition to the Notes Payable Register, debiting the creditor's account and crediting Notes Payable. The amount of the debit would be entered in the Accounts Payable controlling account column for posting at the end of the period.

A form of Note Journal or Register follows:

NOTES RECEIVABLE REGISTER

NOTES RECEIVABLE

No.	When Rec'd	Drawer or Indorser	Drawee or Maker	In Whose Favor	For What Received	Where Payable	Date		
							Year	Mo.	Day

(left-hand page)

NOTES RECEIVABLE

Time	Year	When Due												Amt.	Disposition
		Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.		

(right-hand page)

NOTES PAYABLE REGISTER

NOTES PAYABLE

No.	When Issued	Drawer or Indorser	Drawee or Maker	In Whose Favor	For What Given	Where Payable	Date		
							Year	Mo.	Day

(left-hand page)

NOTES PAYABLE

Time	Year	When Due												Amt.	Disposition
		Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.		

(right-hand page)

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. In handling cash, why is it good policy to deposit all receipts in the bank and make payments by check?
2. How may the bank record and the cash records be checked?
3. What do you understand by the term "petty cash"?
4. What payments are customarily made in money?
5. Explain how a petty cash fund is handled.
6. Describe the operation of a Petty Cash Book and tell how it is posted.
7. When is the Petty Cash account debited and credited?
8. Why should a voucher be made out for each payment of money?
9. Explain the operation of a Sales Returns Journal.
10. Explain the operation of a Purchases Returns Journal.
11. When should these journals be kept?
12. Where are entries recorded if there are no returns journals?
13. Explain the advantages of a Note Register.
14. Give the names of the accounts debited and credited in posting the Note Journals.

CHAPTER XV

SUMMARY OF PRECEDING CHAPTERS

THE material developed in the preceding chapters may be summarized as follows:

1. The balance sheet equation.
2. Changes in the balance sheet equation resulting from business transactions.
3. The dual effect of each transaction on the balance sheet equation, which is the basis for recording transactions by the so-called "double-entry method."
4. The account, its classification and analysis. Development of the theory of debit and credit.
5. The bookkeeping cycle:
 - (a) Recording transactions in the Journal.
 - (b) Posting to the Ledger.
 - (c) The trial balance.
6. Making financial statements:
 - (a) Classification of accounts.
 - (b) The balance sheet.
 - (c) The profit and loss statement.
7. Closing the Ledger.
8. Post closing trial balance.
9. Labor-saving, bookkeeping devices.
 - (a) Subdivision of the General Journal into special journals.
 - (b) The addition of special columns in the journals.
 - (c) Removal of certain ledger accounts from the General Ledger and the keeping of these accounts in special subsidiary ledgers.

(d) The use of controlling accounts to check and control the subsidiary ledgers.

(e) Other special journals and petty cash.

10. Service *versus* trading businesses.

Importance of Balance Sheet Equation. The balance sheet equation ($\text{Assets} = \text{Liabilities} + \text{Capital}$) is the basis for the development of accounting theory. The theory of debit and credit, which is developed from the balance sheet equation, is used in every phase of accounting work.

This balance sheet equation is based upon the fact that everything of value existing in this world has an owner or owners, and that the amount of the owners' interests is limited or equal to the value of the assets.

Effect of Business Transactions on Balance Sheet Equation. Because of business transactions there is a continuous change going on in the character and amount of the assets owned and in the ownership of the assets. Inasmuch as the balance sheet equation from its very nature must always be in balance, a change in one element of the equation will always be counterbalanced by a *like* change in one of the other elements or by an *opposite* change in the same element.

Thus, one asset may increase and another asset decrease, likewise one liability may be increased while another liability is decreased. Also an asset increase may be balanced by a liability or capital increase. Likewise a decrease in an asset may be offset by a liability or capital decrease.

It is evident that because of business transactions the complexion or value of the various elements making up each class of items on the balance sheet equation is always changing.

Accounting analyzes, records and interprets the results of business transactions as they affect the balance sheet equation.

The Account, Its Classification; and Theory of Debit and Credit. Classifications of value, called *accounts*, are used to collect information concerning each class or type of assets, the various interests in these assets, and the changes in the capital interest.

These accounts are divided into two general classes, namely, real accounts and nominal accounts. The real accounts furnish information regarding the assets and the interests in these assets. These accounts are used in preparing the balance sheet. The nominal accounts are accounts which record during the period the increases and decreases of capital resulting from operations. These accounts are used in preparing the profit and loss statement.

The theory of debit and credit was developed from the balance sheet equation as a basis, and applied to individual accounts, according to their classification.

Thus, from the fact that assets are on the left side of the equation, the rule for asset changes was developed as follows:

Debit — increases in value of asset accounts.

Credit — decreases in value of asset accounts.

From the fact that liability and capital accounts are on the right side of the equation the rule for changes in these two classes of accounts was developed as follows:

Debit — decreases in liability or capital accounts.

Credit — increases in liability or capital accounts.

A rule for determining debits and credits may be stated as follows:

Debit the appropriate account:

1. For an increase in assets.
2. For a decrease in liability.
3. For a decrease in capital.

Credit the appropriate account:

1. For an increase in liability.
2. For an increase in capital.
3. For a decrease in assets.

These rules were then applied to various transactions and to many different accounts.

It should be noted that in analyzing a transaction to determine the debit and credit, the procedure is as follows:

1. Analyze the transaction as to the accounts affected.
2. Determine the classification of each account.
3. Determine whether the account is to be debited or credited, by applying the above rules for debit and credit.
4. Record the result of the above analysis in the Journal.

Double Entry Bookkeeping. Double entry bookkeeping applies the theory of debit and credit to various transactions, *enters* the dual effect in records, called Journals, and later transfers the debits and credits so recorded to the proper accounts in the Ledgers.

Double entry bookkeeping is that system of bookkeeping which records both the debit and the credit for every transaction.

The Bookkeeping Cycle. The keeping of bookkeeping records, in accordance with the principles of accounting, consists of journalizing, posting, and the trial balance.

Journalizing is the process of applying the theory of debit and credit to business transactions as they occur, and recording the resulting debit and credit elements in the Journal.

This is the most important of all the bookkeeping processes, because upon it rests the value of all the other steps. An error made in the analysis of a transaction is a *mistake*

in principle, and even though the remainder of the bookkeeping work is performed correctly, such an error may destroy the value of the entire records.

Great care should be exercised in journalizing, so that mistakes in principle may be avoided. This type of error is not revealed by the trial balance and is consequently most dangerous.

The next step in the bookkeeping cycle is the posting. This process is merely the summarizing in the Ledger of the debits and credits entered in the Journal. It has been defined as the transferring of the debits and credits from the Journal to the proper accounts in the Ledger.

After the posting is fully completed, usually at the end of an accounting period, a trial balance is taken from the Ledger. The trial balance checks the accuracy of the posting and the arithmetical work in the books, and also serves as a basis for the analysis of the various accounts of the business.

While the trial balance serves a very important function, it must be remembered that it is not an absolute proof of the accuracy of the work.

Errors not shown by the trial balance are errors in principle, and posting to the wrong accounts. These errors may only be revealed by an analysis of the amounts on the trial balance or by analysis of the original entries.

Preparation of Financial Statements. The first step in the preparation of the financial statements is to classify the accounts of the trial balance.

Accounts are divided into two general classes, real and nominal. The real accounts furnish the information regarding the assets and the interests in these assets. The nominal accounts are temporary capital accounts which

record during the period the increases and decreases in capital resulting from operations.

The trial balance furnishes an abstract of all the open accounts on the Ledger at a given date. These accounts are then analyzed into the two groups, real and nominal, to determine the capital and the result of operations for the period.

The Balance Sheet. The balance sheet is a statement which furnishes the information concerning the assets owned, the liabilities and the capital.

This is the most important statement taken from the books as it shows the real values owned and the ownership thereof at a particular moment of time.

Other names for the balance sheet are: *Statement of Assets and Liabilities*, *Statement of Condition*, *Statement of Resources and Liabilities*.

Profit and Loss Statement. This statement explains in detail the increase and decrease in the capital for the period. The nominal accounts, from the trial balance analysis, are listed in this statement and the difference between the income and the expense accounts is the net profit or loss for the period.

The profit and loss statement merely supplements the balance sheet by giving the details of the increase or decrease in capital and is, therefore, subsidiary to the balance sheet.

Other names applied to the profit and loss statement are: *Income Sheet*, *Income and Expense Statement*, *Statement of Revenue and Expense*, *Statement of Operations*, *Loss and Gain Statement*.

Closing the Ledger. The proprietor's Capital account on the trial balance does not agree with his Capital account on

the balance sheet, due to the fact that the Capital account on the balance sheet includes the net profit or loss for the period. This net profit or loss is shown on the trial balance and Ledger by the expense and income accounts.

In order that these expense and income accounts may be merged with the Capital account, as shown on the trial balance, and bring it into agreement with the Capital account, as shown by the balance sheet, the operation of closing the books is performed.

This operation consists of bringing the accounts on the Ledger into agreement with the statements which were prepared.

The income and expense account balances are transferred to a summary account called the Profit and Loss account. The balance of this account, if a debit, represents a loss and is transferred to the debit of the Capital account; if the balance is a credit, it represents a profit and is transferred to the credit of the Capital account.

In making entries to close the Ledger, the profit and loss statement is used as a basis for determining the accounts to be debited and credited.

After closing the Ledger all nominal accounts should balance, and the amount of the Capital account in the Ledger should be the same as the amount shown on the balance sheet.

Post Closing Trial Balance. Since the nominal accounts have been closed, the only accounts which remain open are the Real accounts, namely, Asset, Liability and Capital accounts. These accounts should satisfy the equation

$$[\text{Assets} = \text{Liabilities} + \text{Capital}.$$

To prove this, a post closing trial balance is taken, which in all essentials agrees with the balance sheet.

CHART OF ACCOUNTING EQUATIONS AND CYCLE OF OPERATIONS

Equations on Ledger	Accounting Operations	
	In Books	Separate from Books
I. $A = L + C_1^*$ Opening entry or Balance Sheet from preceding period after closing Changes in equation due to transactions bring following equation on Ledger	1. <i>Journalizing</i> (a) Transactions performed (b) Analyzed as to debit and credit (c) Recorded in Journal 2. <i>Posting</i> Debits and credits transferred from Journal to Ledger	
II. $A + E = L + C_1 + I$ Closing the Ledger results in Equation III	←————→	3. <i>Trial Balance</i> $A + E = L + C_1 + I$ Taken from Ledger Proof of accuracy Basis of analysis for (4) 4. <i>Financial Statements</i> (a) Working Sheet (b) Profit and Loss Statement (c) Balance Sheet
III. $A = L + C_2^*$	5. <i>Closing Entries</i> (a) Entered in Journal (b) Posted to Ledger ←————→	6. <i>Post Closing Trial Balance</i>

* C_1 = Capital at the beginning of the period.

C_2 = Capital at the end of the period.

$C_2 - C_1 = I - E$ = Net Profit or Loss.

$C_2 = C_1 + I - E$ = Capital at start plus Net Profit or minus Net Loss.

The chart on the preceding page outlines the changes in the balance sheet equation and the various steps or operations in the accounting cycle.

The starting equation is the investment of the proprietor or the balance sheet at the end of the preceding period. The transactions during the period are reflected in the bookkeeping processes of journalizing and posting. The resulting equation on the Ledger is the trial balance equation.

This equation is used as the basis of the financial statement procedure. The grouping of the accounts into real and nominal groups, by using a working sheet, arranges and adjusts the account values correctly so that properly drawn up statements may be prepared. These operations are performed separately from the books, and are a very important part of the work of the accountant.

After the statements are prepared, the operations to close the books are performed in the Journal and Ledger. The posting of the closing entries closes all nominal accounts and brings the Capital account on the Ledger into agreement with the Capital account as shown on the balance sheet.

The final equation of accounts remaining on the Ledger, which is a balance sheet equation, is the starting equation for the next period, when the same cycle of operations is carried out. It is essential that this final equation be correct and in balance because any errors in the closing operations will make it impossible to obtain a trial balance at the end of the next accounting period, even though all the journalizing and posting in this period is correctly performed. The post closing trial balance, therefore, is a check on the closing operations.

Bookkeeping Devices to Save Labor. In order to economize in time and labor, the General Journal, which was

first used as the *sole* book of original entry, was subdivided into special journals, in each of which one type of transaction was recorded. In these special journals the debit and credit for each transaction were indicated in the manner which resulted in the greatest economy of time in making the entry and in the subsequent postings.

The introduction of special columns in the special journals accomplishes further economies in the recording and in the posting of transactions.

The Ledger was likewise subdivided by removing therefrom the accounts with customers and the accounts with creditors and keeping them in separate ledgers, called the Accounts Receivable Ledger and the Accounts Payable Ledger. In place of all the individual accounts receivable removed from the General Ledger there was substituted one account, called Accounts Receivable, which shows in one amount the total of these accounts. In place of all the individual accounts payable removed from the General Ledger there was substituted one account, called Accounts Payable, which shows in one amount the total of these accounts.

The General Ledger accounts, Accounts Receivable and Accounts Payable, act as substitutes for the individual accounts carried in the subsidiary ledgers. Since the balances of these two accounts are always equal to the sum of the balances of the individual accounts in the subsidiary ledgers, they are said to control these ledgers.

Controlling accounts provide a check or control on the subdivisions of the accounting work and thus it is possible to divide the bookkeeping procedure among many assistants with no loss in accuracy.

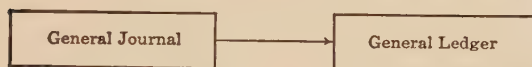
The handling of cash is one of the principal problems in every business enterprise. With the development of the

cash journals there is also a Petty Cash Journal, which is used by most businesses to take care of the many small payments which are of necessity made in cash.

Several other special journals are used in business when the transactions of any special class become sufficiently numerous to warrant them. The Sales Returns, Purchases Returns, Notes Receivable and Notes Payable Journals are illustrated and explained.

CHARTS OF ACCOUNTING SYSTEMS

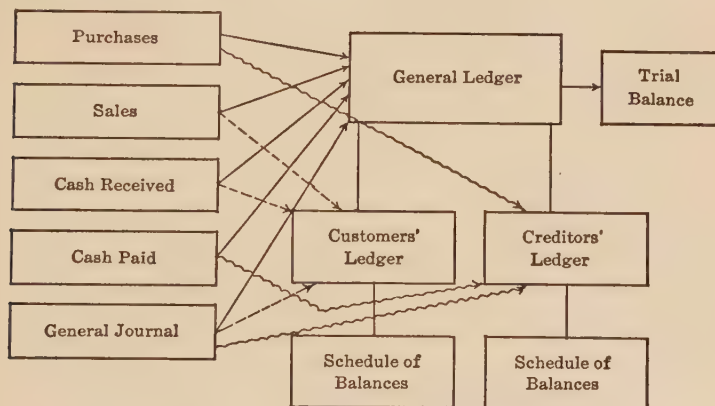
I.



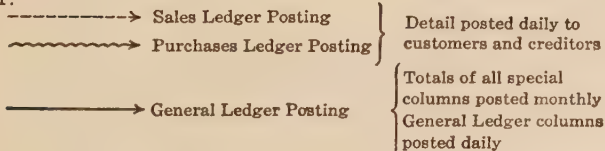
Entries are complete in General Journal and posted to Ledger individually.

II. Special Journals

Controlling Accounts



KEY:



Entries are made in special journals and posted to the Ledgers as indicated above

Service Business. From an accounting viewpoint the service business is the simplest type of business and consequently is best adapted to present the fundamental principles of accounting and the technique of bookkeeping. The service business was therefore used in this text to develop and illustrate the cycle of operations as follows:

1. Journalizing
2. Posting
3. Trial Balance
4. Preparation of Balance Sheet
5. Preparation of Profit and Loss Statement
6. Closing the Ledger

Trading Business. The trading business — that is, a business which buys and sells commodities — was next considered. In this type of business, several accounts, namely, Purchases, Sales, Returned Purchases, Returned Sales, Freight Inward and Merchandise Inventory, were used in order to obtain the gross profit from trading. This gross profit from trading corresponds to the commission income in a service business.

The trading business was used to review the principles of recording and interpreting transactions developed through the service business and in addition was used to develop and explain:

1. The use of special journals
2. The columnar development of the Journal
3. The subdivision of the Ledger
4. The use of controlling accounts
5. Cash discounts and trade discounts
6. Negotiable instruments and banking practice

PART II

CHAPTER XVI

ADJUSTMENTS — INVENTORIES

Business Periods. The life of a business, like the life of an individual, is divided into definite periods of time which, depending on the policy of a particular business, vary in length from a month to twelve months. While a very large proportion of businesses use a twelve-month period as a basis of accounting, yet in recent years many have adopted a six-month or even a three-month period as a basis. A great many firms use a yearly period and close the books at the end of this period, but require monthly or quarterly statements prepared, though the Ledger accounts are not closed until the end of the year. At the close of each business period the business pauses temporarily and determines what its condition is and the results of its operation for the period. In other words, the business has an "accounting."

When the business period is twelve months, it may begin on January 1 and end on the 31st of December, or it may begin and end on any other dates. If the period begins on the 1st of January and ends on December 31, it is said to have a calendar year; a twelve-month period beginning on any date other than January 1 and ending on any date other than December 31 is called a fiscal year.

Natural Business Year. Great care should be taken in selecting the period so that it coincides with the natural business year for that particular type of business. Thus, in a cotton brokerage business, the new business starts in

September; therefore the natural close of the year is August 31. In seasonable businesses it is always well to have the year close one or two months after the termination of the season. In businesses which are not seasonable and when one period is as good as another, the calendar year should be used.

The principal reason for the consideration of the natural business year is the fact that at the end of the seasonal business, the inventories are smaller than when business is good. A larger stock is carried during busy periods. There are mark-down sales which are intended primarily to cut down the inventory to a minimum just before the end of the business year. A smaller inventory is easier to take and may be performed with less trouble and expense and will probably be more accurate. As business is dull, there is more time for the analysis of the business results and for preparation of statements and closing the books.

In a great many businesses the inventory problem is one of major importance, and for this reason largely, seasonal closing, or fiscal periods ending at other dates than December 31, receive favorable consideration by a large number of business firms.

Adjusting Entries. During a business period the transactions are recorded as far as practicable in accordance with their effect on the real and nominal accounts. Some transactions, however, are too complicated or too numerous to permit analyzation into their real and nominal elements as they occur and are entered during the period in the most practical manner and then analyzed in bulk at the close of the period.

A good illustration of this type of transaction is a sales

transaction. A sale of merchandise on account is composed of the following parts:

Asset received	=	Account Receivable
Asset parted with	=	Merchandise
Excess of value received over value parted with	=	Profit

Inasmuch as it would be impracticable to attempt to analyze each sale in the above way, the sales are all credited to the Sales account until the end of the period. The Sales account, therefore, is not a pure income account, since it shows not only the profit realized on the sale, but also the cost of the goods sold.

The Purchases account during the period is charged with all the goods purchased, whether the goods are sold or not. This account, therefore, at the close of the period records both the cost of the goods purchased which have been sold and the cost of the goods purchased which are on hand. It contains, therefore, two elements:

Expense element	=	Cost of the goods sold
Asset element	=	Cost of the goods remaining on hand

An account which contains elements falling under more than one classification has been defined as a *mixed account*.

At the close of a business period prior to the determination of the financial condition or the results of operating, all mixed accounts must be analyzed into their elements and these elements recorded, by means of journal entries, called *adjusting entries*, in their proper accounts.

Again, in another type of transaction the facts at the time of the occurrence of the transaction were properly recorded in the accounts but, due to the passage of time or

other causes, do not reflect at the close of the period the exact status. For example, a business on November 1 receives a 6 per cent interest-bearing note, due in 120 days, amounting to \$10,000. The note at the time of receipt was recorded as follows:

November 1, 19—		
Notes Receivable	10,000	
Accounts Receivable		10,000

To record receipt of A's note
to apply on account for \$10,000,
due February 28, 19—, with in-
terest at 6 per cent.

This entry correctly recorded the facts the day on which this note was received. But on December 31, sixty days have elapsed, and this note is now worth \$10,000 plus sixty days' interest on \$10,000, i.e., \$100. It is worth, therefore, \$10,100. The interest accrued on this note is not recorded in the account, but inasmuch as it represents an addition to the assets of the business, it must be considered prior to the determination of the financial condition or the results of operating.

Information of this type is also brought on to the books by adjusting entries. An adjusting entry may be defined as an entry made in the Journal or otherwise: (1) to separate any mixed accounts into their proper real and nominal elements; or (2) to bring on to the books any information affecting the condition or operating results of a business, which has not been recorded in the records, because the transaction, which would bring it on to the books, has not as yet actually occurred.

Adjusting entries may be classified, therefore, into two groups:

1. Entries made to properly record the elements of mixed accounts.

2. Entries made to bring on to the books information not recorded thereon and which must be considered in the preparation of the statements.

The above classifications will be observed in the succeeding discussion of adjustments.

ADJUSTING MIXED ACCOUNTS

Inventory of Merchandise. The unsold merchandise at the close of the period is called the *inventory* or the *inventory of merchandise*. The value of the goods on hand at the close of a period may be obtained from

1. An actual counting, weighing, listing, and valuing of all the goods on hand at the close of the period. An inventory value obtained in this manner is called a *physical inventory*.
2. Stock records which show units and prices of each item sold and also the number of items on hand. An inventory value obtained in this manner is called a *perpetual* or *running inventory*.
3. An estimate based on the expected standard gross profit included in the sales. By subtracting the expected gross profit from the sales the estimated cost of the goods sold is obtained. By subtracting the estimated cost of the goods sold from the purchases, an approximate value is obtained for the goods on hand.

Without going into a complete discussion or evaluation of the various methods, it will suffice at this point to say that the physical inventory properly taken and correctly priced is preferable to an inventory value obtained otherwise.

The importance of the proper valuation of inventory cannot be stressed too strongly, even at this stage of the

discussion. Very frequently the principal asset owned is the merchandise inventory, and unless this asset is properly valued, the financial condition may be seriously misrepresented.

One of the biggest problems in inventory valuation is the pricing of the various items constituting the inventory. Much controversy exists and many different methods of pricing inventories are advocated, but the one which is followed to the greatest extent is the "cost or market, whichever is the lower," method. This method determines for each item in the inventory the unit cost price at the date of purchase and the unit price at which the article could be purchased on the date of the inventory (called the market price), and then uses the lower of these two unit prices in valuing the article for the inventory.

In the subsequent discussion the merchandise inventories, unless a statement to the contrary is given, will be physical inventories valued according to the rule of "cost or market, whichever is the lower."

Adjustment for Inventory. As explained previously, the Purchases account at the close of the period includes both the cost of the goods sold and the cost of the goods included in the inventory. In other words, this account is composed of two elements, the expense element, which is the cost of the goods sold, and the asset element, which is the cost of the goods in the inventory.

At the close of the period the element which is foreign to the account, according to its normal classification, must be removed. Inasmuch as the Purchases account is classified as an expense account, the asset element, the value of the inventory, is removed and recorded in a separate asset account. The adjusting entry to accomplish this is:

	Date	
Merchandise Inventory (or Inventory)		xxxx
Purchases		xxxx

To record the value of the inventory as of 12/31 in the Merchandise Inventory account and remove this amount from the Purchases account.

Inventory at the Beginning of the Period. Obviously the inventory at the close of the period becomes the beginning inventory for the next accounting period. These goods are merely the purchases of one period which are carried forward into the next period and are then merged with the other purchases made during this subsequent accounting period. No attempt is usually made to keep the identity of the goods included in the inventory separate from the purchases, consequently no particular purpose is served in keeping the inventory amount in a separate account. An entry may be made either at the beginning or end of the succeeding accounting period to merge the inventory at the beginning of the period with the purchases. The entry to accomplish this is:

	Date	
Purchases		xxxx
Merchandise Inventory		xxxx

To charge the Purchases account with the inventory as of 1/1 and to close the Merchandise Inventory account.

As stated previously, this entry may be made either at the beginning or end of the new period. If the making of this entry is deferred until the close of the new period, it should be made before the entry for the goods on hand at the close of this period is made.

Adjustment for Stationery and Supplies. It is customary for the sake of convenience and for the resulting economies to purchase stationery and office supplies in quantities greater than is required for present use. Consequently, at the end of the fiscal period, some of the stationery and supplies purchased during the period and charged to the expense account, Stationery and Supplies, will be on hand. The stationery and supplies on hand are valued at the cost price and are an asset.

An adjustment at the end of the period is made to record the value of the stationery and supplies on hand as an asset and to remove their value from the expense account, Stationery and Supplies.

The *pro forma* entry to make this adjustment is:

	Date	
Stationery and Supplies on Hand		xxxx
Stationery and Supplies		xxxxx

To transfer from the expense account, Stationery and Supplies, to the asset account, Stationery and Supplies, on Hand, the value of the unused stationery and supplies.

Adjustment for Prepaid Insurance. Fire insurance is paid in advance usually for one, three, or five years. The amount of the premium at time of payment is charged either to the Insurance account, which is an expense account, or to the Prepaid Insurance account, which is an asset account. If the premium is charged to the Insurance account, the amount of the prepaid insurance must, at the end of the period, be removed from this account and recorded in the asset account, Prepaid Insurance.

The *pro forma* entry to make this adjustment is:

	Date	
Prepaid Insurance		XXXX
Insurance Expense		XXXX

To transfer from the expense account, Insurance, to the asset account, Prepaid Insurance, the insurance paid in advance calculated as follows:

Premium paid	XXXX
Portion charged to this period	<u>XXX</u>
Prepaid insurance	XXXX

If the premium at the time of payment is charged to the asset account, Prepaid Insurance, an adjustment must be made at the end of the period for the insurance which has expired and which is chargeable as an expense.

The *pro forma* entry to make this adjustment is:

	Date	
Insurance Expense		XXXX
Prepaid Insurance		XXXX

To transfer from the asset account, Prepaid Insurance, to the expense account, Insurance, the amount of insurance expired during the period calculated as follows:

Total premium	XXXX
Value of unexpired premium	<u>XXX</u>
Expired insurance for the period	XXXX

Adjustment for Interest Paid in Advance on Notes Payable Discounted. As explained previously the discount charged by a bank on a note payable which is discounted is merely interest paid in advance. This interest paid in advance entitles the maker of the note to the use of the

amount of the loan for the specified period of time. If the time for which the note is given extends beyond the fiscal period in which it is discounted, an adjustment must be made for the interest paid in advance. In other words, the Interest Expense account has been charged not only for the cost of the money used for this fiscal period but has also been charged with the cost of the use of the money for a certain time into the next fiscal period.

The right to use money for a certain length of time in the future is an asset. The Interest Expense account contains two elements in it at the close of the period, namely, the expense element, which is the cost of the use of the money, the benefits of which were received during the fiscal period, and the asset element, which is the value of the right to use money for a certain length of time in the future. It is, therefore, a mixed account.

The Interest Expense account is properly an expense account; consequently, the element which, at the end of the period, is incorrectly recorded in this account is the asset element, i.e., the value of the right to use money for the future.

The *pro forma* entry made to remove the asset element, interest paid in advance, from the Interest Expense account is:

	Date	
Prepaid Interest		xxxx
Interest Expense		xxxx

To remove from the Interest Expense account the interest paid in advance calculated as follows:

Discounted with	Amount	Period in Advance	Rate	Interest
.....				
.....				

There are many more adjustments which might be classified under the first type of adjustments, namely, to properly record the elements of mixed accounts, but the illustrations given are typical of all adjustments of this kind and further ones would be pure repetition.

Adjusting Entries of the Second Type — Accruals. The following adjustments illustrate the second type, namely, adjustments made to bring on to the books essential financial information not recorded thereon. This class of adjustments is called *accruals* because of the fact that the benefits or losses have accrued up to the end of the period, although the time for the transaction to actually happen has not arrived.

Adjustment for Interest Accrued on Notes Receivable. Interest accrues from day to day, thus the interest-bearing notes receivable, which are recorded at the time they are received at face value, do not reflect at the close of a period, the interest which is accrued. This accrued interest represents an increase in the amount owned, the asset, and an increase in the income earned during the period.

The interest accrued on unpaid interest-bearing notes receivable is recorded at the close of the period by the following entry:

	Date	
Interest Accrued on Notes Receivable		xxxx
Interest Income		xxxx

To record the interest accrued to date on the following interest-bearing notes receivable:

Maker	Face	Time	Rate	Interest
.....				
.....				

Adjustment for Interest Accrued on Notes Payable. At the close of the fiscal period there is a certain amount of interest accrued on the unpaid interest-bearing notes payable which has not been recorded in the books. This accrued interest is an additional amount owed, a liability, and is an increase of the interest expense for the period.

The interest accrued on unpaid interest-bearing notes payable is recorded at the close of the period by the following entry:

	Date	
Interest Expense		XXXX
Interest Accrued on Notes Payable		XXXX
To record the interest accrued to date on the following interest-bearing notes payable:		

Payee	Amount	Time	Rate	Interest
.....				
.....				

Adjustment for Taxes. Taxes are assessed to the owner of property on a certain day each year, irrespective of what becomes of the property after the date of the assessment. The amount of the taxes assessed is payable at some later date. Thus, in a State which assesses the taxes on the basis of property owned on April 1, payable in October, the owner of the property is assessed for the taxes and liable for them whether he retains or disposes of the property assessed.

While the exact amount of the tax bill is not known until it is received, yet it is customary, in preparing statements between the date of assessment and the date on which the tax bills are rendered, to bring on to the books an estimate of the amount of taxes which is accruing, debiting the

expense account, Taxes, and crediting the liability account, Taxes Accrued.

The *pro forma* entry made to record the estimated taxes is as follows:

	Date	
Taxes		XXXX
Taxes Accrued		XXXX
To record the estimated taxes accrued for the period to based on an assessment for the year of		

When the tax bill is received in October, the actual amount of the tax is determinable. If the estimate for the first six months was too high, an entry may be made to adjust the accounts as follows:

	Date	
Taxes Accrued		XXXX
Taxes		XXXX
To adjust the above accounts in accordance with the tax bill.		
Original estimate of taxes		XXXX
Taxes per bill		XXXX
Overestimate of tax		xxx

If the taxes were underestimated, the preceding entry would be reversed.

An entry may then be made to bring on to the books the entire tax bill, charging one half of the bill to Taxes Accrued and the other half to Taxes Prepaid. The following entry would be made:

	October 1, 19—	
Taxes Accrued		XXXX
Taxes Prepaid		XXXX
Taxes Payable (or Cash)		<u>XXXX</u>
To record the tax bill for the year April 1, 19—, to March 31, 19—.		

At the close of each month thereafter one sixth of the amount charged to the Taxes Prepaid account would be written off and charged to the Taxes account so that by March 31 of the next year the entire amount would be written off.

If the books are closed at December 31, there will be three months' taxes prepaid and the accounts should be adjusted accordingly.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What are the natural business years in the following industries?
 - (a) wool blanket mill;
 - (b) toy factory;
 - (c) silverware business;
 - (d) ice cream business;
 - (e) manufacturer of bricks;
 - (f) automobile sales agency.
2. What advantage, if any, results in having the fiscal year of a business coincide with the natural business year?
3. Give full illustrations of mixed accounts.
4. Distinguish between
 - (a) closing entries;
 - (b) current entries;
 - (c) correcting entries;
 - (d) adjusting entries.
5. Express your understanding of the purpose of adjusting entries. Illustrate your answer.
6. What should be included in the inventory of merchandise?
7. If the inventory was valued at cost and the market or replacement value was below cost, what effect would this produce in
 - (a) the profit or loss for the period?
 - (b) the financial condition?

8. If the inventory was valued at cost and the market or replacement value was higher than cost, what effect would this produce in
 - (a) the profit or loss for the period?
 - (b) the financial condition?
9. Why is a physical inventory preferable to inventories taken otherwise?
10. How would you justify taking an inventory at cost or market, whichever is the lower?
11. Name several other mixed accounts needing adjustment.
12. What is an accrual?
13. What is the difference between entries for mixed accounts and entries for accruals?
14. Explain the handling of the Taxes account.
15. Explain the adjustment of the Insurance account.
16. Explain the adjustment of prepaid interest.
17. Explain the adjustment of accrued interest receivable, and accrued interest payable.

CHAPTER XVII

ADJUSTMENTS

DEPRECIATION — RESERVE ACCOUNTS

Fixed Assets and Depreciation. In considering adjustments, attention must be given to changes in the valuation of certain assets resulting from their use, or lapse of time. Furniture and fixtures, office appliances, and other assets purchased with the intention of using them (as instruments) in carrying on the business will gradually, through such use or other causes, wear out or otherwise become worthless.

Assets which are purchased for use in carrying on the business operations are called *fixed assets*. Examples of fixed assets are: land, buildings, machinery, furniture and fixtures, office appliances, automobiles, etc.

The loss in value of fixed assets due to their use or other causes is called *depreciation*. All fixed assets, with the exception of land, from their very nature are subject to loss from the wear and tear of use, from the action of heat, cold, and the elements, from a change of style, from supersession by more improved types, and from innumerable other causes. This loss resulting from depreciation is an expense or cost of using the asset in the business. It may be spread over a few or many years, but inevitably there comes a day when the asset must be discarded, or when it should be discarded because it no longer renders efficient service. Depreciation, therefore, is one of the necessary costs which the owner of the fixed assets must pay for the use of these assets and as such must be recorded as one of the expenses of doing business.

Calculation of the Charge for Depreciation. In determining the amount of depreciation to be charged each period, the following elements must be considered:

1. Original cost of the asset.
2. The estimated useful life of the asset.
3. The value of the asset at the end of its life, called the scrap or residual value.

The original cost of the asset should include the invoice cost, transportation charges, and the cost of the installation, if any.

The estimated life is determined from experience with similar assets, and from a consideration of the conditions surrounding the use of these assets in a particular business.

The scrap or residual value is an estimate of the value of the asset at the end of its life as junk or as a second-hand article.

Knowing and determining these three elements, the amount of the periodic charge for depreciation is determined in practice by several different methods. The method illustrated in this chapter, known as the straight line method, is the one most frequently used in practice. A full discussion of the other methods is given in a later chapter.

The amount of depreciation charged as an expense each period is obtained by subtracting the scrap or residual value from the cost and dividing this difference (called the total depreciation) by the number of periods in the estimated life.

For example, the annual charge for depreciation on office appliances which cost \$1,800 and have an estimated residual value of \$300 and an estimated life of six years is found as follows:

Formula:

$$\frac{\text{Cost less Residual Value}}{\text{Number of Years of Life}} = \text{Annual Depreciation Charge}$$

Substituting the given figures:

$$\frac{\$1,800 - \$300}{6} = \$250 \text{ — the Annual Expense Charge}$$

In many cases in practice no consideration is given to scrap value, and the asset is depreciated on the full cost value.

Depreciation Based on Estimate. The charge for depreciation is based on an estimate of the length of time the asset may be used and what it will be worth when it has reached the end of its service life. This estimate may be too high or too low, but in the absence of any absolutely determinable figure, it should be used as a basis for charging each period with its portion of the loss. When the asset has reached the end of its life, the estimate may be adjusted to correspond with the actual loss which then becomes definitely known.

Depreciation Account. The Depreciation account for any asset is classified as an expense account. It is debited, usually at the end of a period, with the estimated amount of the depreciation of the asset. This same amount is credited to the Reserve for Depreciation account. The Depreciation account is a nominal account and it is closed into the Profit and Loss account when the books are closed.

Reserves for Depreciation. The estimated amount of the loss in the value of the fixed assets for each period is debited to the expense account, Depreciation. Since this charge is based on the theory that the fixed asset has declined in value, a credit to the asset account might be made to indicate this loss. As the periodic charge, however, is only an

estimate and may require adjustment at a later date, it is better to credit these amounts to a separate account called Depreciation Reserve (asset name). Using this method each fixed asset is recorded through two accounts, namely, the *Asset account proper*, which records the cost of the asset; and the *Reserve for Depreciation* account for this particular asset, which records the total estimated decline in value of the asset.

Book Value of Assets. The Asset account and the Reserve for Depreciation account should always be considered together. The difference between the fixed asset account and its corresponding reserve for depreciation account is known as the *book value* of the asset.

Meaning of "Reserve." The word "reserve" as applied to a Reserve for Depreciation account is somewhat misleading as it seems to imply a setting aside of something. Actually nothing is set aside, but provision is made for actual loss in value of an asset by crediting the amount of the loss to the Reserve account. This account shows at any time the total provision which has been made for loss in the value of the asset through the periodic charges for depreciation. It is merely the credit side of a fixed asset account, showing at any time the estimated decline in value. In reality, a reserve is made from profits, due to the fact that if no entry for depreciation were made, the profits transferred to the Capital account would have been that much larger. The Reserve account, therefore, represents profits withheld from Capital to take care of expected losses resulting from the depreciation of fixed assets.

Use of Reserve for Depreciation Account. The use of the Reserve for Depreciation account may be summarized as follows:

Reserve for Depreciation of (name of asset) is

Credited: At the end of each period for the amount charged against the income as depreciation.

Debited: During the life of the asset for the original cost of any renewals or replacements which prolong the life of the asset beyond the original estimate; at the time of the discarding of the asset for the amount of the balance which is reflected in this account (at the same time crediting the asset).

Balance: The balance of this account is normally a credit and is classified as an asset valuation account.

Reserves for Depreciation on Balance Sheet. The balance of the Reserve for Depreciation account should be shown on the balance sheet, preferably as a deduction from the corresponding asset.

Thus, the reserve for depreciation on office appliances at the end of three years at \$250 per year would be shown on the balance sheet as follows, under Fixed Assets:

Office Appliances (Cost)	\$1,800
Less:	
Depreciation Reserve	<u>750</u> \$1,050

Entries for Depreciation. At the end of each period the entry made to charge the depreciation as an expense and to credit the amount so charged to the Reserve account may be summarized as follows:

	Date	
Depreciation of (Name of Asset)		xxxx
Reserve for Depreciation (Asset Name)		xxxx
To record the periodic charge for depreciation calculated as follows:		
Cost of Asset	xxx	
Rate of Depreciation	<u>x%</u>	
Depreciation	xxx	

At the end of the estimated life the Depreciation Reserve account may be closed into the Asset account by the following entry:

Date	
Reserve for Depreciation (Asset Name)	xxxx
Asset Account	xxxx

To close Reserve account into the Asset, as the asset is now 100% depreciated.

For example, the office appliances previously referred to, which cost \$1,800 and are estimated to be worth \$300 as scrap in six years, are depreciated for six years at \$250 per year.

At the end of the six years the accounts would appear as follows, supposing no other entries appear in the accounts:

Office Appliances		Reserve for Depreciation of Office Appliances	
1923	1,800	1923	250
		1924	250
		1925	250
		1926	250
		1927	250
		1928	250
			<u>1,500</u>

The following entry may now be made:

Date	
Reserve for Depreciation — Office Appliances	1,500
Office Appliances	1,500

To close Reserve account into the Asset, as the asset is now entirely depreciated.

The accounts after posting this entry would appear as follows:

Office Appliances				Reserve for Depreciation of Office Appliances			
1923	1,800	1928	1,500	1928 (To Close) 1,500	1923	250	
					1924	250	
					1925	250	
					1926	250	
					1927	250	
					1928	250	
					<u>1,500</u>	<u>1,500</u>	

The Asset account now reflects the actual scrap value of the asset. If the asset is subsequently sold for \$300 cash and the Asset account is credited, the account balances and is, therefore, closed. If the asset is sold for more than the scrap value, the excess represents a profit from the sale of a capital asset; if sold for less, the difference is a loss on the sale of a capital asset.

Sale of Asset before End of Estimated Life. When an asset is sold before the end of its estimated life, an adjustment is required, provided it is sold for more or less than the book value on the date of the sale. The book value of an asset represents the depreciated cost value, and if it is sold at this value, there is no gain or loss realized. If sold for more than this book value, a gain is realized; if sold for less, a loss is realized.

In case of a sale of fixed asset for greater or less than the book value, entries may be made to correct the depreciation which has been charged, but as these corrections only affect the capital, the adjustment for the gain or loss will accomplish the same result.

For example: An automobile is purchased January 1, 1927, for \$1,500 and is depreciated 20 per cent per year for

three and one half years. On July 1, 1930, a new automobile costing \$1,800 is purchased and an allowance is made of \$325 on the old automobile as a trade-in by the Auto Sales Company. The loss on the exchange is calculated as follows:

Cost of First Automobile	\$1,500
Depreciation — $3\frac{1}{2}$ years	<u>1,050</u>
Book Value	450
Allowance Made	<u>325</u>
Loss on Sale of Automobile	\$125

The Ledger accounts will appear as follows:

Automobiles		Reserve for Depreciation — Automobiles	
1927		1927	300
Jan. 1	1,500	1928	300
		1929	300
		1930 to	
		July 1	150

The following entries would be made in the Journals on or about July 1, 1930, to indicate the adjustments necessary and to show correctly the condition of the Asset and Reserve accounts.

These entries would vary according to the circumstances in each case, but the loss or gain on the asset should be recorded. Certain entries would be made in the Cash Book or Invoice Register and others in the General Journal.

Entries to be made on July 1, 1930:

July 1, 1930		
Depreciation		150
Reserve for Depreciation — Automobiles		150
Depreciation on Buick		
Cost	1,500	
Depreciation $\frac{1}{2}$ year; rate 20% yearly	<u>150</u>	

July 1, 1930		
Reserve for Depreciation — Automobiles	1,050	
Loss on Sale of Automobile	125	
Automobiles		1,175

To close Reserve account and to show
loss on sale of automobile.

Buick car cost	1,500
Depreciation $3\frac{1}{2}$ years	<u>1,050</u>
Book value	450
Allowance by Auto Co.	<u>325</u>
Loss on sale	<u><u>125</u></u>

July 1, 1930		
Automobiles	1,475	
Cash		1,475

To record purchase of new car.

New Buick, cost	1,800
Allowance on old car	<u>325</u>
Balance as cash	<u><u>1,475</u></u>

After posting these entries the Ledger accounts previously illustrated on page 269 will appear as follows:

Automobiles				Reserve for Depreciation — Automobiles			
1927		1930		1930		1927	300
Jan. 1	1,500	July 1	1,175	July 1	1,050	1928	300
1930						1929	300
July 1	1,475					1930	150
					<u>1,050</u>		<u>1,050</u>

Note: The balance of this account now shows cost of new car, \$1800.

The Reserve for Depreciation account, in so far as it concerns the automobile sold, is now closed, as the automobile has been disposed of.

The account, Loss on Sale of Automobile, is a nominal account and will be closed into the Profit and Loss account at the end of the period.

Gain on Sale of Assets. Example: Suppose an asset which cost \$3,000 is depreciated 20 per cent yearly, and suppose that after five years the asset is disposed of for \$3,000 — just what it cost. There has been no loss by depreciation, still the asset is fully depreciated. It is evident in such a case that the estimated depreciation is greater than the actual depreciation, and the profits withheld or reserved from capital may now be carried to the Capital account directly or through the Profit and Loss account. (See page 272.)

The accounts with the asset and the reserve would appear as follows, after the entries recorded below were posted:

December 31, 1925

Depreciation — Fixed Asset	600	
Reserve for Depreciation — Fixed Asset		600

To record estimated depreciation at
20% yearly.

(Same entry each year)

December 31, 1929

Cash (or Other Asset)	3,000	
Fixed Asset		3,000

To record sale of asset for cash.

Fixed Asset				Reserve for Depreciation — Fixed Asset	
1925	3,000	1929		1925	600
		Dec. 31	3,000	1926	600
				1927	600
				1928	600
				1929	600
					3,000

Suppose that the sale of the asset took place on the last day of the fifth year of its use. An entry may be made to adjust the above reserve account as follows:

December 31, 1929

Reserve for Depreciation — Fixed Asset	3,000	
Capital Account — (Name of Owner)		3,000

To transfer to the Capital account the
depreciation on "Fixed Asset," which was
charged off during the past five years.

This entry might be credited to the Profit and Loss account as a Gain on Sale of Capital Assets. Adjustments such as the above will receive further treatment in a later chapter. At the present time it should be noted that a gain on the sale of depreciated assets returns to capital some profits previously withheld, and a loss on sale of depreciated assets requires a reduction of capital for further losses not charged to profit and loss.

Provision for Loss on Uncollectible Accounts. In practically every business which sells merchandise on credit losses occur due to the inability of customers to pay their debts. The amount of such losses varies widely from year to year: in some years there will be no losses, while in other years, due usually to economic conditions, the losses are very heavy.

Actual Loss Method of Accounting for Uncollectible Accounts. One method of accounting for such losses is to charge them as losses in the year in which they are sustained. When a loss is sustained an entry is made charging the account used to record such losses and crediting the customer's account for the amount of the loss. The entry may be illustrated as follows:

	Date	
Loss on Bad Debts		xxxx
Accounts Receivable (Customer's Name)		xxxx
To charge the loss on account of (Customer's Name) and to write his account off the books.		

Objections to Actual Loss Method. The actual loss method charges off all accounts in the period in which they are determined to be uncollectible, irrespective of whether the accounts were the *result of the sales of that period* or

some other period. Usually the period which is charged with the greatest amount of losses from uncollectible accounts is a period which shows a small or no profit before considering bad debts. Consequently, the charging of all the bad debts which were sustained in this period to the Profit and Loss account results in a further reduction of income or increase of the loss. This policy results in a wide fluctuation in the operating results of the business and creates an unfavorable impression of its stability.

Estimated Loss Method of Accounting for Bad Debts.

Another method of handling losses from bad debts is the so-called estimated or reserve method. The amount charged off each period by this method is an estimated amount which is based on the past experience either of a certain business or of others in the same trade or type of business. A period of years in the past is taken and the ratio of the losses in those years to the net charge sales, or to any other logical base, is determined. This percentage or approximately this percentage is then used in estimating the probable loss for the next succeeding period.

The amount of the estimated loss may be determined by any of the following methods:

1. By inspection of the accounts and estimating the accounts which will probably become uncollectible. Accounts thus considered bad are usually transferred to a Suspense Ledger of accounts considered worthless.
2. By taking a certain percentage of the net sales or net charge sales.
3. By taking a certain percentage of the open accounts receivable balance, as shown by the controlling account.

To illustrate: Assume that the losses from bad debts in a given business over a period of five years amounted to

\$2,500, and that the net charge sales for this period were \$500,000. The per cent of loss is, therefore, one half per cent. This rate or approximately this rate, depending upon future policies and credit conditions, is then used for each succeeding period in making provision for such losses.

The loss on bad debts thus determined is charged to the expense account, Estimated Loss on Bad Debts, and the corresponding credit is to the account, Reserve for Loss on Bad Debts. The use of this account is necessary because there are at the time no specific customers' accounts which are known to be worthless and consequently none of the accounts receivable can be actually written off the books.

When any customers' accounts are actually known to be worthless, under this method, they are charged to the Reserve account.

The use of the account, Reserve for Bad Debts, may be summarized as follows:

Reserve for Bad Debts is

Credited: At the end of each fiscal period for the estimated loss from uncollectible accounts for the period. The corresponding debit is to the expense account, Estimated Loss on Bad Debts.

Debited: For the actual bad accounts when they are definitely ascertained to be worthless. The corresponding credit is to the various customers' accounts.

Balance: The balance is normally a credit and is classified as an asset valuation account.

Entry for Estimated Bad Debts. The form of entry to record the estimated loss from uncollectible accounts is the same, irrespective of the method used in obtaining the amount of the estimated loss. The form of entry may be illustrated by the following entry:

Date			
Estimated Loss on Bad Debts		XXXX	
Reserve for Loss on Bad Debts			XXXX
To set up a reserve for expected losses on bad accounts calculated as follows:			
Net charge sales for period		xxx	
Average % of loss in past		xx%	
Amount of estimated loss		XXXX	

The use of the estimated loss method tends to spread the losses from bad accounts over the various years in such a manner that the ratio of losses is equalized. When the actual losses are sustained they are charged against the reserve account and consequently such actual losses have *no effect* on the profit and loss for the year.

The following illustration shows the Reserve account as it may appear on the Ledger of a business.

Reserve for Bad Debts

1925				1925			
July 1	J. S. (Bankrupt)	375		Dec. 31	1% 250,000 Sales	2,500	
1926				1926			
Sept. 1	C. Mfg. Co. Failure	3,250		Dec. 31	1% 275,000	2,750	
1927	No Loss			1927			
1928	Bad Accounts	5,200		Dec. 31	1% 300,000	3,000	
1929	Bad Accounts	2,200		1928			
Dec. 31	Balance	2,975		Dec. 31	1% 285,000	2,850	
				1929			
				Dec. 31	1% 290,000	2,900	
		<u>14,000</u>				<u>14,000</u>	
				1930			
				Jan. 1	Balance	2,975	

More frequently in practice the word "estimated" is omitted from the title to the Expense account and the title "Loss on Bad Debts" is used as in the actual loss method.

Accounts Charged off as Worthless Later Collected.

When an account which has been charged off as worthless is later collected, an entry should be made to bring the account back on the books.

Example: Suppose in 1930 the William Maxwell & Co. account for \$450 was paid. During 1928 this account had been charged off by the following entry:

Date — 1928		
Reserve for Bad Debts	450	
William Maxwell & Co. (Accounts Receivable)		450
To charge off this account as it is considered worthless.		

In 1930 the following entry was made in the Cash Book for the cash received:

Date — 1930		
Cash	450	
William Maxwell & Co.		450
Received cash on account 1927 debt.		

The following adjustment entry should now be made in the Journal:

Date — 1930		
William Maxwell & Co. (Accounts Receivable)	450	
Reserve for Bad Debts		450
To bring on the books the bad debt of William Maxwell & Co. written off in 1928.		

The effect of the above entry is to put back in the Reserve account an amount previously taken out.

If the actual loss method had been used when charging off the account of William Maxwell & Co., the entry for the cash received in 1930 should be as follows:

Date — 1930

William Maxwell & Co. (Accounts Receivable)	450	
Capital Account (or Profit & Loss)		450

To bring back on to the books an account charged off as worthless in 1928.
The customer has paid the account.

Date — 1930

Cash	450	
William Maxwell & Co.		450

To record cash received on 1928 account.

These entries have the effect of putting back into Capital an amount charged off as a bad account in 1928 and collected in 1930.

Comparison of the Two Methods of Providing for Loss on Bad Debts.

<i>Actual Loss Method</i>	<i>Reserve Account Method</i>
1. Accounts examined and all worthless accounts written off at the close of the period as a definite charge to Profit and Loss.	1. An estimated amount based upon experience is charged to Profit and Loss.
2. Taken care of in (1).	2. Actual loss on bad debts charged to Reserve for Loss on Bad Debts when determined actually worthless. No effect on Profit and Loss.
3. Charges to Profit and Loss vary widely and bear no relationship to income for a given period.	3. Charges to Profit and Loss are quite uniform and are usually in direct relationship to income.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Define a fixed asset.
2. What is depreciation?
3. Why is depreciation considered an expense of doing business?
4. Explain how depreciation may be calculated.

5. What is the effect of crediting the amount of the estimated depreciation to the Reserve for Depreciation account?
6. If the credit for the estimated depreciation is made to the Asset account, what difference does it make? Explain.
7. Define "book value" of an asset.
8. What is the meaning of "Reserve" as used in the Reserve for Depreciation account?
9. State for what the Reserve for Depreciation account is debited and credited.
10. How is the Reserve for Depreciation account shown in a balance sheet?
11. When an asset is fully depreciated what happens to the Reserve for Depreciation account?
12. When an asset is sold or exchanged before the end of its estimated life, explain what happens.
13. Explain the two methods of accounting for uncollectible accounts.
14. What entry is made for loss on bad accounts under the "actual loss" method?
15. Give the entry under the "estimated loss" method.
16. Compare the two methods as to their effect on capital and profit and loss from operations.
17. If a bad debt is charged off as a loss and later collected, explain how it is handled.

CHAPTER XVIII

WORKING SHEETS AND ANALYSIS SHEETS

Working Sheets. To facilitate the consideration of the figures assembled in the Ledger it is customary at the close of a period to copy the trial balance on a sheet of columnar paper. The trial balance furnishes a convenient basis for the making of the necessary adjustments and for the analyzing of the figures for the statements. A columnar sheet which is used in the assembling and analyzing of financial facts is called a *working sheet*.

There is no stereotyped form of working sheet; the form, the number of columns, and the columnar captions depend entirely upon the convenience of the person using the sheet and the purpose for which it is to be used.

A simple form has been illustrated in Volume I. No adjustments were used, therefore the form contained only six columns. A form commonly used in the assembling and analyzing of the figures for the statements when adjustments are necessary consists of the following sections:

Section 1. Names of the accounts used.

Section 2. Two money columns for the debit and credit balances, respectively, of the accounts.

Section 3. Two money columns for the debit and credit adjustments to the accounts.

Section 4. Two money columns for the adjusted trial balance figures.

Section 5. Two money columns for the debit and credit balances of the nominal accounts appearing in Section 4.

Section 6. Two money columns for the debit and credit balances of the real accounts appearing in Section 4.

Illustration of Procedure in Making a Working Sheet.

To illustrate the use of a working sheet, the figures taken from the books of William Kent on July 31, 19—, will be used. This complete working sheet is shown between pages 290 and 291.

Step 1. The working sheet is headed as follows:

William Kent
Working Sheet for the Preparation of Statements
July 31, 19—

This heading is preferably placed on the left side of the sheet.

Step 2. The columnar captions are inserted as described in Sections 1 to 6 on the sheet inserted between pages 290 and 291.

Step 3. A copy of the trial balance as of July 31, 19—, is made on the working sheet, putting the account names in Section 1 and the debit and credit balances of these accounts in Section 2.

Step 4. The trial balance is now scrutinized for accounts which are mixed or otherwise require adjustment.

(a) *Interest Accrued on Notes Receivable.* The first account in the trial balance which suggests an adjustment is the Notes Receivable account. The notes constituting this account are examined to determine whether or not there is any accrued interest. The following interest-bearing notes are on hand:

Maker	Face	Time Held	Rate	Accrued Interest
H. H. Hall	\$2,400.00	21 days	6%	\$8.40
N. O. Dolan	900.00	16 days	6%	<u>2.40</u> \$10.80

An adjusting Journal entry is now made to record this information, as follows:

A.

Interest Accrued on Notes Receivable	10.80	
Interest Income		10.80

To record the interest accrued on the following interest-bearing notes receivable:

Maker	Face	Time Held	Rate	Accrued Interest
H. H. Hall	\$2,400	21 days	6%	\$8.40
N. O. Dolan	900	16 days	6%	<u>2.40</u>

This information is now entered on the working sheet. Inasmuch as the Interest Accrued on Notes Receivable account does not appear on the trial balance taken from the books, it is now written below the other account names of the trial balance. The amount of interest accrued is entered on the line with the name of the account and in the debit column of the adjustment section. The credit to the account, Interest Income, is entered on the line with this account name and in the credit adjustment column.

This adjustment is lettered "A" and this letter should be entered for identification beside each of the amounts entered in the adjustment columns.

(b) *Provision for Uncollectible Accounts.* The next account which suggests an adjustment is the Accounts Receivable account. The policy of this concern is to estimate the loss from bad accounts as one per cent of the net sales. The net sales for the period ending July 31, 19—, is \$65,162.35. The estimated loss from bad debts is, therefore, \$651.62.

The following entry is made to record the provision for bad accounts:

B

Estimated Loss on Uncollectible Accounts	651.62	
Reserve for Loss on Uncollectible Accounts		651.62
To provide for loss from bad accounts based on 1% of net sales for period.		
Gross Sales	\$65,422.45	
Less: Returns & Allow-		
ances	260.10	
Net Sales	<u>\$65,162.35</u>	

This information is now recorded in the adjustment columns of the working sheet. As neither of these accounts appears in the original trial balance they are opened below and the amount of the debit and credit is written in the adjustment columns on the line with the name of the account. The letter "B" should be written beside each amount.

(c) *Merchandise Inventory at Beginning of Period.* The next account appearing on the trial balance which requires adjustment is the Merchandise Inventory account. The debit amount of this account represents the value of the inventory at the beginning of the period. As these goods have been either sold or combined with the purchases for the period, the amount of this account should be transferred to the Purchases account.

The following entry is made to accomplish this:

C

Purchases	6,870.65	
Merchandise Inventory		6,870.65
To transfer the value of the goods on hand January 1, 19—, from the Merchandise Inventory account to the Purchases account.		

This adjustment is entered in the adjustment columns of

the working sheet on the lines with these accounts. The letter "C" should be placed beside each amount.

(d) *Inventory of Merchandise at Close of Period.* The inventory of merchandise on July 31, 19—, should now be entered in the Merchandise Inventory and removed from the Purchases account. The value of the goods on this date is \$8,470.50. The following entry is made to record this inventory:

D		
Merchandise Inventory	8,470.50	
Purchases		8,470.50

To record the value of the goods on hand on July 31, 19—, in the Merchandise Inventory account and to remove this amount from the Purchases account.

This adjustment is entered in the adjustment columns of the working sheet and the letter "D" placed beside each amount.

(e) *Depreciation of Furniture and Fixtures.* The next account which suggests an adjustment is the Furniture and Fixtures account. The depreciation on this asset account for the seven months must be considered. The rate of depreciation to be used for these assets is 10 per cent. The following entry is made to provide for the depreciation on furniture and fixtures:

E		
Depreciation of Furniture and Fixtures	165.89	
Reserve for Depreciation of Furniture and Fixtures		165.89

To record the charge for depreciation on furniture and fixtures for seven months calculated as follows:

$$\$2,840 \times .10 \times \frac{7}{12} = \$165.89$$

This adjustment is entered in the adjustment columns of the working sheet and the letter "E" placed beside each amount.

(f) *Depreciation of Office Appliances.* The next account which suggests an adjustment is the Office Appliances account. The depreciation on this asset account for the seven months must be considered. The rate of depreciation used is $16\frac{2}{3}$ per cent. The following entry is made to record the depreciation on this asset:

F	
Depreciation of Office Appliances	155.54
Reserve for Depreciation of Office Appliances	155.54

To record the depreciation on office appliances for seven months calculated as follows:

$$\$1,600 \times .16\frac{2}{3} \times \frac{7}{12} = \$155.54$$

This information is properly entered in the adjustment columns of the working sheet. Accounts must first be opened below the original trial balance. The letter "F" should be written beside each amount.

(g) *Interest Accrued on Notes Payable.* The next account which suggests an adjustment is the Notes Payable account. An investigation must be made to determine if there is any accrued interest on the unpaid interest-bearing notes payable. The following information is obtained:

Payee	Amount	Time	Rate	Accrued Interest	
F. D. Sayles	764.70	5 days	6%	.64	
M. N. Mason	1,500.00	36 days	6%	<u>\$9.00</u>	\$9.64

The following entry is made to record this accrued interest:

G		
Interest Expense	9.64	
Interest Accrued on Notes Payable		9.64

To record the accrued interest to
date on the unpaid notes payable.

Payee	Amount	Time	Rate	Accrued Interest
F. D. Sayles	\$764.70	5 days	6%	.64
M. N. Mason	1,500.00	36 days	6%	<u>9.00</u>

This information is now entered on the working sheet and the letter "G" placed beside each amount.

(h) *Stationery and Supplies on Hand.* The next account which suggests an adjustment is the Stationery and Supplies account. All the stationery and supplies purchased during the period have been charged to this account and it is found that on July 31, 19—, there are unused supplies on hand valued at \$160.00. This amount should be recorded as an asset and removed from the Stationery and Supplies account. The following entry accomplishes this:

H		
Stationery and Supplies on Hand	160.00	
Stationery and Supplies		160.00

To transfer from the expense account, Stationery and Supplies, the value of the unused portion, and record the same in the asset account, Stationery and Supplies on Hand.

This entry will be properly recorded in the adjustment columns of the working sheet and the letter "H" placed beside each amount.

(i) *Prepaid Insurance.* The next account which requires

adjustment is the Insurance account. This account has been charged with the total insurance paid for the period on the stock and fixtures. This insurance was taken out June 1, 19—, for one year; consequently, the unexpired insurance would be for ten months, which would amount to \$250.00. The following entry is made to adjust the accounts:

I		
Prepaid Insurance	250.00	
Insurance		250.00

To record the unexpired insurance as of July 31, 19—, and remove same from the Insurance account. The amount is calculated as follows:

Premium paid 6/1 —	
for 1 yr.	\$300.00
Less: One sixth of above	50.00
Unexpired insurance	<u>\$250.00</u>

This information is properly entered in the adjustment columns and the letter "I" placed beside each amount.

(j) *Prepaid Interest.* The next account which suggests an adjustment is the Interest Expense account. All the interest paid during this period has been charged to the Interest Expense account, including the discount paid to the bank on the \$4,000 note discounted. Inasmuch as the business has the right to use this money for 39 days after July 31, 19—, the value of this use (\$26.00) should be set up as an asset on July 31, 19—.

This interest having been charged to the Expense account is considered paid, though actually it is not paid until the note itself is redeemed. It is customary, however, to charge this interest in advance because the face of the note is set up as a liability at the discount date.

The following entry is made for this adjustment:

J		
Prepaid Interest	26.00	
Interest Expense		26.00

To set up the prepaid interest as of July 31, 19—, and to remove the same from the Interest Expense account. The amount is calculated as follows:

Note to	Amount	Time	Rate	Interest
Lincoln Trust	\$4,000.00	39 days	6%	\$26.00

This information is recorded in the adjustment columns and the letter "J" placed beside each amount.

(k) *Taxes Accrued.* All the adjustments suggested by the trial balance accounts have now been made and the only item which has not been taken into consideration is the taxes accruing on the personal property of the business since April. This is estimated to amount to \$60.00 for the four months April to July inclusive. The following entry is made to record this information:

K		
Taxes	60.00	
Taxes Accrued		60.00

To set up the estimate of the taxes for personal property for the period April to July inclusive.

This adjustment is now entered in the adjustment columns of the working sheet and the letter "K" entered beside each amount.

Step 5. The debit and credit adjustment columns of the working sheet are now added in order to check the accuracy of the work. Obviously, if all the adjustments have been properly entered therein the columns will balance.

Step 6. The amounts in Section 2 — i.e., the original trial balance — are now adjusted by the amounts in Section 3 — i.e., the adjustment columns. The combined figures are now extended into Section 4 — i.e., the adjusted trial balance section.

Inasmuch as the amount of inventory at the beginning of the period, the amount of the purchases for the period, and the amount of the inventory at the close of the period are going to be shown as separate figures in the profit and loss statement, it is suggested that these figures be carried into the adjusted trial balance figures without combination. In other words, show in the debit column the amount of the purchases for the period and immediately above this amount show the amount of the inventory at the beginning of the period. In the credit adjustment column, on the line with the Purchases account, show the amount of the inventory at the close of the period.

This suggestion is based on a practical principle used in preparation of working sheets. Never combine figures on a working sheet which will subsequently be reanalyzed for the statements.

Step 7. The two columns of the adjusted trial balance section are added as a check on the accuracy of the work up to this point.

Step 8. Each account in the adjusted trial balance is now either a nominal or a real account, and the amounts should be extended into either the Nominal Section (Section 5) or the Real Section (Section 6).

Step 9. The nominal section columns are next added and the totals placed beneath the last figure of each column. The amount of the debit column is then subtracted from the amount of the credit column (*vice versa*

if the amount of the debit column exceeds the amount of the credit column). This difference, which is the net profit, is entered in the debit column of the Nominal Section and also in the credit column of the Real Section and the words "Net Profit" placed under the accounts in Section 1. The columns in the Nominal Section should now be footed and balanced.

Step 10. Both the columns of the Real Section are now added. The totals of these columns should now balance. This is a very valuable check and insures to a very great degree the accuracy of the work. This proof is based on the formula —

Assets = Liabilities + Reserves + Capital + Net Profit

Working Sheet not a Statement. It should be borne in mind that the working sheet is merely a means of accumulation and of analyzation of the figures for the preparation of the statements and does not take the place of the formal profit and loss statement nor the balance sheet. These statements may now be easily prepared from the working sheet since all the figures to be used in the profit and loss statement are contained in the Nominal Section of the working sheet and the figures used in the balance sheet are contained in the Real Section of the working sheet.

The procedure of preparing the working sheet outlined above is subject to many variations. Few accountants follow the same procedure in all particulars in the preparation of such a sheet, but the essential principles are the same. The method of handling the inventories used in this explanation seems best for classroom purposes and, in fact, may be followed in practice with satisfactory results.

Model for Working Sheet. The working sheet prepared from the trial balance of William Kent, which may serve as a model, is shown in the sheet which follows.

1 ACCOUNTS	2			3			
	TRIAL BALANCE BEFORE ADJUSTING			ADJUSTMENTS			
	Dr.		Cr.	Dr.		Cr.	
Cash	395009						
Petty Cash	6650						
Notes Receivable	430000						
Acceptances Receivable	280060						
Accounts Receivable	591595						
Merchandise Inventory	687065			D	847050	C	6870
Furniture and Fixtures	284000						
Office Appliances	160000						
Acceptances Payable			86050				
Notes Payable			626470				
Accounts Payable			757110				
William Kent -- Drawing	245000						
William Kent -- Capital			1087185				
Sales			6542245				
Sales Returns and Allowances	26010						
Purchases	4403230			C	687065	D	8470
Freight Express & Cartage In	59330						
Purchase Returns & Allowances			60000				
Salaries	760000						
Rent	420000						
Stationery and Supplies	21710					H	160
Telephone and Telegrams	13530						
Insurance	30000					I	250
Traveling Expense	205630						
Advertising	82000						
General Expense	47060						
Interest Income			16125			A	19
Discount on Purchases			85491				
Interest Expense	27624			G	964	J	26
Discount on Sales	85173						
	9260676	9260676					
Interest Accrued on Notes Rec.				A	1080		
Estimated Loss on Accts. Rec.				B	65162		
Res. for Loss on Accts. Rec.						B	651
Depr. of Furniture & Fixtures				E	16569		
Res. for Dpr. of Furn. & Fixt.						E	165
Depr. of Office Appliances				F	15554		
Res. for Dpr. of Office Appliances						F	155
Int. Accrued on Notes Pay.						G	9
Stationery and Supplies on Hand				H	16000		
Prepaid Insurance				I	25000		
Prepaid Interest				J	2600		
Taxes				K	6000		
Taxes Accrued						K	60
					1683044		16830
Net Profit							

ATION OF STATEMENTS

4				5 NOMINAL				6 REAL			
TRIAL BALANCE		AFTER ADJUSTING		Dr.		Cr.		Dr.		Cr.	
3950	09							3950	09		
66	50							66	50		
4300	00							4300	00		
2800	60							2800	60		
5915	95							5915	95		
8470	50							8470	50		
2840	00							2840	00		
1600	00							1600	00		
		860	50							860	50
		6264	70							6264	70
		7571	10							7571	10
2450	00							2450	00		
		10871	85							10871	85
		65422	45			65422	45				
260	10			260	10						
6870	65			6870	65						
44032	30	8470	50	44032	30	8470	50				
593	30			593	30						
		600	00			600	00				
7600	00			7600	00						
4200	00			4200	00						
57	10			57	10						
135	30			135	30						
50	00			50	00						
2056	30			2056	30						
820	00			820	00						
470	60			470	60						
		1720	5			1720	5				
		8549	1			8549	1				
259	88			259	88						
851	73			851	73						
10	80							10	80		
651	62			651	62						
		651	62							651	62
165	69			165	69					165	69
		165	69							165	69
155	54			155	54					155	54
		155	54							155	54
		964								964	
160	00							160	00		
250	00							250	00		
260	00							260	00		
60	00			60	00						
		60	00							60	00
102130	55	102130	55								
				6229	80					6229	80
				755199	1	755199	1	32840	44	32840	44



Recording of Adjusting Entries in the Journal. When the working sheet is completed and the statements prepared, the adjusting entries may or may not be recorded in the Journal, according to circumstances.

If the books are to be closed, because it is the end of the accounting period, the adjusting entries should be recorded in the Journal along with the closing entries. By referring to the index letters in the Adjustments Section of the working sheet the debit and credit for each adjusting entry may be determined and recorded properly in the Journal.

When these adjusting and closing entries are posted to the accounts, the Ledger is closed and brought into agreement with the balance sheet as prepared from the working sheet.

These adjusting entries may be made in journal form before recording them on the working sheet, or they may be recorded first on the working sheet and made in journal form afterwards. It does not matter which method is used provided the entries in both places agree. It is only when the books are to be closed that the adjusting entries are made in the General Journal and posted to the Ledger accounts.

When the books are not to be closed, no adjusting or closing entries are made in the General Journal and the values reflected on the trial balance are not changed. They are carried along into the next period.

Analysis Sheet Method of Preparing Financial Statements. Another method which may be used in the preparation of financial statements is the *Analysis Sheet Method*. This method is a development from the Chart of Accounts, classified as to real accounts and nominal accounts. One account is used for the Real or Balance Sheet group and another account for the Nominal or Profit and Loss group.

These sheets are called "Analysis Sheets" because they are used in arranging the values from the separate accounts as they are to appear in the statements. They are not statements, and may contain abbreviations and corrections, but are arranged in account form, approximating the account form of statement.

The trial balance account values are first placed on the analysis sheets, in their proper classification, leaving space between each group for additional items which will appear from the adjustments.

Adjustments are made directly on the analysis sheets, debiting and crediting the proper accounts in the proper position on the face of the analysis sheets. These adjustments are lettered or numbered so that they may be readily traced or checked. A ledger-ruled form may be used for the analysis sheets.

The same problem used in the illustration of the working sheet will be used to demonstrate the analysis sheet method. The trial balance and adjustment information is repeated for convenience in illustrating the solution by this method.

The real accounts in this trial balance are entered on the analysis sheet for real accounts and the nominal accounts on the analysis sheet for nominal accounts. Then the adjustments are entered directly on these same analysis sheets. The balance of each analysis sheet will be the same amount. (The net profit or the net loss.)

WILLIAM KENT

TRIAL BALANCE, JULY 31, 19—

Cash	\$3,950.09	
Petty Cash	66.50	
Notes Receivable	4,300.00	
Acceptances Receivable	2,800.60	
Accounts Receivable	5,915.95	
Merchandise Inventory, 1/1/—	6,870.65	
Furniture and Fixtures	2,840.00	
Office Appliances	1,600.00	
Acceptances Payable		\$860.50
Notes Payable		6,264.70
Accounts Payable		7,571.10
William Kent, Drawing	2,450.00	
William Kent, Capital		10,871.85
Sales		65,422.45
Sales Returns and Allowances	260.10	
Purchases	44,032.30	
Freight, Express and Cartage In	593.30	
Purchases Returns and Allowances		600.00
Salaries	7,600.00	
Rent	4,200.00	
Stationery and Supplies	217.10	
Telephone and Telegraph	135.30	
Insurance	300.00	
Traveling Expense	2,056.30	
Advertising	820.00	
General Expense	470.60	
Interest Income		161.25
Discount on Purchases		854.91
Interest Expense	276.24	
Discount on Sales	851.73	
	<u>\$92,606.76</u>	<u>\$92,606.76</u>

Prepare financial statements, taking into consideration the following adjustments:

1. Interest Accrued on Notes Réceivable, \$10.80.
2. Estimated Loss on Bad Debts, 1% Net Sales.
3. Merchandise Inventory on Hand, July 31, 19—, \$8,470.50.
4. Depreciation on Furniture and Fixtures, 10% Yearly.
5. Depreciation on Office Appliances, $16\frac{2}{3}\%$ Yearly.
6. Interest Accrued on Notes Payable, \$9.64.
7. Stationery and Supplies on Hand, \$160.00.
8. Prepaid Insurance, \$250.00.
9. Prepaid Interest on Notes Payable Discounted, \$26.00.
10. Taxes Accrued, \$60.00.

Step 1. Prepare on two sheets of standard size ($8\frac{1}{2} \times 11$) paper skeleton accounts, one for the real accounts and the other for the nominal accounts. These accounts are divided into sections by means of horizontal lines drawn lightly across the paper. The sections correspond to the sections and divisions of the two statements to be prepared. See model analysis sheets, pages 296–97.

Step 2. Record the debit and credit balances with the account names on the proper analysis sheet, being careful to place each account in the approximate position that it will have in the finished statement. The analysis sheet forms (see pages 296, 297) for the trial balance of William Kent illustrate this operation.

Note: The Merchandise Inventory which is on the trial balance is not an asset. It is used in the Trading section of the Profit and Loss Statement as an addition to Purchases. It is, therefore, placed on the debit side of the analysis sheet for nominal accounts. This inventory is numbered 1 for convenience as it is the old or beginning inventory. The final inventory is numbered 2 also for convenience and to distinguish it from the old inventory.

The proprietor's Drawing account is a Capital account with a debit balance and is listed on the debit side of the Analysis sheet for Real accounts. This method of indicating subtractions from certain accounts is used on the analysis sheets.

Provided there were no adjustments these analysis sheets would show the values of all accounts arranged in proper classification for the statements.

Step 3. Enter on the analysis sheets the adjustments which are necessary.

These adjustments in the case of William Kent are as follows:

(a) Interest Accrued on Notes Receivable, \$10.80.

This represents an asset as the amount of interest is actually accruing and represents a realizable value. It also represents an income.

The following entry would be necessary to bring this item on the books:

Interest Accrued on Notes Receivable	10.80	
Interest Income		10.80

To record the interest accrued to
July 31 on notes on hand.

This information is entered on the analysis sheets by placing the interest accrued on notes receivable on the real account sheet as a current asset and on the nominal account sheet as an income. The income amount may be entered above or below the interest income, as shown on the non-operating income section of the analysis sheet.

This adjustment is labeled (1), and this mark of identification should be entered at the left of each of the amounts recorded on the analysis sheets.

Note: When the statements are prepared all amounts affecting the same account are added or subtracted and one net figure is used to show the resulting condition of this account.

(b) Estimated Loss on Bad Accounts Receivable, 1 per cent of net sales.

WILLIAM KENT

ANALYSIS SHEET — REAL ACCOUNTS

July 31, 19—

ASSETS		DEBITS	LIABILITIES	CREDITS
Current	Cash	395009	Acceptances Pay	86050
	Petty Cash	6650	Notes Pay.	626470
	Notes Rec.	430000	Accounts Pay.	757110
	Acceptances Rec.	280060		
	Accounts Rec.	591595		
Fixed				
	Furn. & Fix.	284000		
	Office Appl.	160000		
Deferred Charges				
			CAPITAL	
	William Kent, Drawing Acct.	245000	William Kent, Cap. Acct.	1087185

The following entry is made to set up the reserve which in this concern is estimated to be 1 per cent of the net sales.

Loss on Bad Debts	651.62	
Reserve for Loss on Bad Accounts		651.62
To provide for expected loss.		
Gross Sales	\$65,422.45	
Returned Sales	260.10	
Net Sales	<u>\$65,162.35</u>	
1%	<u>651.62</u>	

This information is recorded on the analysis sheets, debiting Loss on Bad Accounts in the non-operating section of the analysis sheet for nominal accounts, and crediting Reserve for Bad Debts on the credit side of the analysis sheet for real accounts. This credit should be placed opposite Accounts Receivable, as this amount is used as a subtraction from the Accounts Receivable account in the finally prepared Balance Sheet statement. Number (2) is placed to the left of each amount.

(c) Merchandise Inventory on Hand July 31, \$8,470.50.

The following entry is made to bring this amount into the records:

Merchandise Inventory	8,470.50	
Purchases		8,470.50
To set up the present inventory.		

This inventory is the final or number (2) inventory and is an asset. It is entered in the current asset section of the real accounts and in the credit side of the trading section of the nominal accounts. Number (3) is placed at the left of each amount.

The old inventory has been placed in the nominal accounts in the trading section and, therefore, requires no

adjustment. An entry must be made in the Journal to combine this old inventory value with purchases, in the General Ledger. This entry may be made as an adjusting entry or as a closing entry.

(d) Depreciation on Furniture and Fixtures 10 per cent yearly.

This 10 per cent is figured usually on the cost value as shown by the trial balance account. In this problem it is figured for seven months.

The following entry should be made to set this item up on the books:

Depreciation on Furniture and Fixtures	165.69	
Depreciation Reserve, Furniture and Fixtures		165.69

To set up reserve for depreciation for seven months.

$$\$2,840 \times 10\% \times \frac{7}{12} = \$165.69$$

This information is recorded on the analysis sheets by entering Depreciation on Furniture and Fixtures in the operating expense section of the nominal accounts as a debit and the reserve for depreciation as a credit in the real accounts opposite the corresponding asset account. The number (4) is placed at the left of both accounts.

(e) Depreciation on Office Appliances $16\frac{2}{3}$ per cent yearly.

The following entry would be made to set up this item on the books:

Depreciation on Office Appliances	155.54	
Depreciation Reserve, Office Appliances		155.54

To set up the reserve for depreciation for the seven months' period.

$$\$1,600 \times 16\frac{2}{3}\% \times \frac{7}{12} = \$155.54$$

This information is recorded on the analysis sheets in the same manner as number (4). The number (5) is placed at the left of each amount.

(f) Interest Accrued on Notes Payable, \$9.64.

The following entry would be made to record this information.

Interest Expense	9.64	
Interest Accrued on Notes Payable		9.64
To record interest accrued to date on unpaid notes payable.		

This information is recorded on the analysis sheets by entering the interest expense in the non-operating expense section of the nominal accounts as a debit, and in the current liability section of the real accounts as a credit. Number (6) is placed at the left of each amount.

(g) Stationery and Supplies on Hand, \$160.00.

Stationery and supplies when purchased have been charged to the Stationery and Supplies account, an expense account. The amount of the inventory may be removed from the expense account and set up as an asset account by the following entry:

Stationery and Supplies on Hand	160.00	
Stationery and Supplies		160.00
To transfer from the expense account the value of the inventory of supplies on hand, and to record the same in the asset account, Sta- tionery and Supplies on Hand.		

This information is recorded on the analysis sheets by entering the asset account in the deferred charges section of real accounts and the same amount as a credit in the

nominal accounts, opposite the expense account, Stationery and Supplies. This credit represents a subtraction from the debit amount. On the profit and loss statement the remainder only is shown as the expense for stationery and supplies. Number (7) is placed to the left of each amount.

(h) Prepaid Insurance, \$250.00.

The amounts of insurance premiums when paid were charged to the Insurance account, which is an expense account. As insurance premiums were paid in advance for one year from June 1, 19—, the prepaid or unexpired insurance would be \$250.00, or five sixths of \$300.00.

The following entry would adjust this account:

Prepaid Insurance	250.00	
Insurance		250.00
To record unexpired insurance as of July 31, 19—.		
Amount paid June 1 for		
1 year	\$300.00	
Less: One sixth	50.00	
Unexpired	<u>\$250.00</u>	

This information is recorded on the analysis sheets by recording prepaid insurance under deferred charges in the real accounts and crediting Insurance account on the income side of the nominal accounts. This credit is entered opposite the expense account. Number (8) is entered at the left of each amount.

(i) Prepaid Interest on Notes Payable Discounted, \$26.00.

The discount on the \$4,000 notes payable was debited to the Interest Expense account when the note was discounted. As the note does not mature until thirty-nine days after July 31, the interest for this time is carried over

WILLIAM KENT

ANALYSIS SHEET — REAL ACCOUNTS

July 31, 19—

ASSETS		DEBITS	LIABILITIES	CREDITS
Current				
	Cash	395009	Acceptances Pay.	86050
	Petty Cash	6650	Notes Pay.	626470
	Notes Rec.	430000	Accounts Pay.	757110
	Acceptances Rec.	280060	Int. Acc. Pay. (6)	964
	Accounts Rec.	591595	Res. Bad Debts (2)	65162
	Int. Acc. Rec. (1)	1080	Taxes Acc. (10)	6000
	Mdse. Inv. #2 (3)	847050		
Fixed				
	Furn. & Fix.	284000	Depr. Res. (4)	16569
	Office Appl.	160000	Depr. Res. (5)	15554
Deferred Charges				
	Stat'y & Sup. on Hand (7)	16000		
	Prepaid Ins. (8)	25000		
	Prepaid Int. (9)	2600		
			CAPITAL	
	William Kent, Drawing	245000	William Kent, Capital	1087185
	Total Debits	2284044	Total Credits	2661064
	Total Credits	2661064		
	Net Profit	622960		

into the next accounting period, as this period has the use of the money for the thirty-nine days remaining.

The following entry would adjust the accounts:

Prepaid Interest	26.00	
Interest Expense		26.00

To set up the prepaid interest as
of July 31 and remove the same
from the Interest Expense account.

This information is recorded on the analysis sheet by entering prepaid interest, \$26.00, as a deferred charge on the asset side of the real accounts. Interest expense is credited by an entry on the income side of the nominal accounts. Number (9) is entered at the left of each amount.

Note: Interest expense now has two debits and one credit, which are merged into one amount when the profit and loss statement is prepared.

(j) Taxes Accrued, \$60.00.

On the basis of the previous year's tax bill the taxes from April 1 to July 31 are estimated to be \$60.00.

The following entry would record this information:

Taxes	60.00	
Taxes Accrued		60.00

To bring into the accounts the
estimated taxes for the period
April 1 to July 31, inclusive.

This information is reflected on the analysis sheets by recording taxes as a debit under operating expense for \$60.00 in the nominal accounts and taxes accrued as a credit under current liabilities for \$60.00 in the real accounts. Number 10 is entered at the left of each amount.

All adjustments having been made and recorded, the analysis sheets will appear as illustrated on pages 302 and 303.

Step 4. The analysis sheets are now added and the total debits and credits are subtracted and the balance or excess is determined.

This balance will be the net profit or loss for the period. If a net profit, the analysis sheet for real accounts will show a balance on the debit side, and the analysis sheet for nominal accounts will show the same balance on the opposite or credit side. If a net loss, the balance would be on the reverse side in each account.

It is quite evident that the balancing figure will always be equal on both sheets provided the original debits and credits in the trial balance are placed in the proper columns and provided all adjustments are properly recorded.

It should be noted that the trial balance figures are placed in one place only, while all adjusting entry amounts must be recorded twice, once as a debit and once as a credit.

When the analysis sheets are completed, as illustrated, it is a very simple matter to set up *pro forma* statements from the analysis sheets. See pages 109–112 for the finished statements.

Comparison of the Methods. The working sheet is the older form and has been used by accountants, with variations, for many years. It shows the trial balance, adjustment entry values, adjusted trial balance, and real and nominal account values in parallel columns extending horizontally across the page. It is a technical form which is the accountant's own record of his analysis of the accounts for statement purposes. It is a useful form where careful analysis is needed and where many adjustments are used.

The analysis sheet plan accomplishes the same results as the working sheet plan, but in a different manner. This plan is really a short-cut working sheet and accomplishes

the rough set-up of the statements in a more rapid manner than the working sheet plan. Standard Ledger account forms are used and are divided into sections approximating the arrangement in the account form of statement. All entries are made directly in the accounts and the arrangement and classification of each account is determined as it is entered on the sheets.

For speedy determination of the net profit or loss result and for class demonstration and quizzes, the analysis sheet plan is recommended.

Recording of Adjusting Entries in the Journal. Adjusting entries may be recorded in the Journal for posting by referring to the analysis sheets for the debits and credits. As explained under the working sheet (page 291) adjusting entries may or may not be entered in the Journal, according to circumstances.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Define a working sheet.
2. What is the relationship between the working sheet and the balance sheet and profit and loss statement?
3. Enumerate the advantages of using the working sheet as a means of assembling and analyzing all the figures to be used in the statements.
4. Explain the method of handling the inventories of merchandise on the working sheet.
5. In what respects does the adjusted trial balance differ from the original trial balance taken from the Ledger?
6. In case the amount of the credit column of the Nominal Section exceeds the amount of the debit column of this section, what does this difference represent?

7. In which column of the Real Section is the difference obtained in Question 6 placed? Why?
8. In case the amount of the debit column of the Nominal Section exceeds the amount of the credit side, what does the difference represent?
9. In which column of the Real Section is the difference obtained in Question 8 placed? Why?
10. How does the placing of the difference between the columns of the Nominal Section in the Real Section check the accuracy of the work?
11. Explain the analysis sheet method of analyzing accounts for statement purposes.
12. How are the analysis sheets prepared?
13. How are the trial balance figures recorded in the analysis sheets?
14. Explain the manner of recording adjustments in the analysis sheets.
15. Why does the net profit show on the debit side of the real accounts?
16. Why are statements easily prepared from the analysis sheets?
17. Compare the analysis sheet plan and the working sheet plan.
18. Of what advantage are these plans for statement preparation?

CHAPTER XIX

THE BALANCE SHEET

The Balance Sheet. In a previous chapter an elementary form of balance sheet was illustrated and discussed solely to emphasize the relationship of the elements of the equation, $\text{Assets} = \text{Liabilities} + \text{Capital}$. In the balance sheet illustrated therein the assets were all shown together without classification and without regard to their availability in meeting the demands of the creditors. Such a balance sheet falls far short of accurately portraying the financial condition of a business at a particular moment of time.

In this chapter another form of balance sheet is presented which classifies and groups the items so that the value of the various types of assets and the interests in those assets may be presented in a comprehensible manner.

Subdivision of Assets. The assets discussed up to this point in the text may be classified as follows:

Current Assets

Fixed Assets

Deferred Charges to Profit and Loss

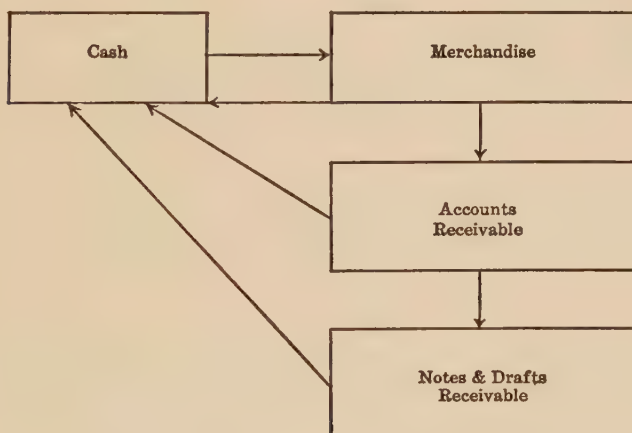
Current Assets. The term *current assets* includes cash and all other assets which have been acquired in the ordinary conduct of the business and which, in the regular course of the business, are to be reconverted into cash within a reasonable length of time. The distinguishing characteristics of current assets are:

1. Acquisition in the ordinary conduct of the business.
2. Intention of and ability to reconvert into cash in the regular course of the business.

3. Expectation of conversion into cash within a reasonable period, which varies from a few months to a year.

Current assets are also called *quick*, *floating*, *liquid*, and *working assets*. Illustrations of current assets are: Cash, accounts receivable, notes receivable, drafts receivable, and merchandise inventory.

These assets are called current because of the continual flow from cash back to cash, as illustrated by the following diagram:

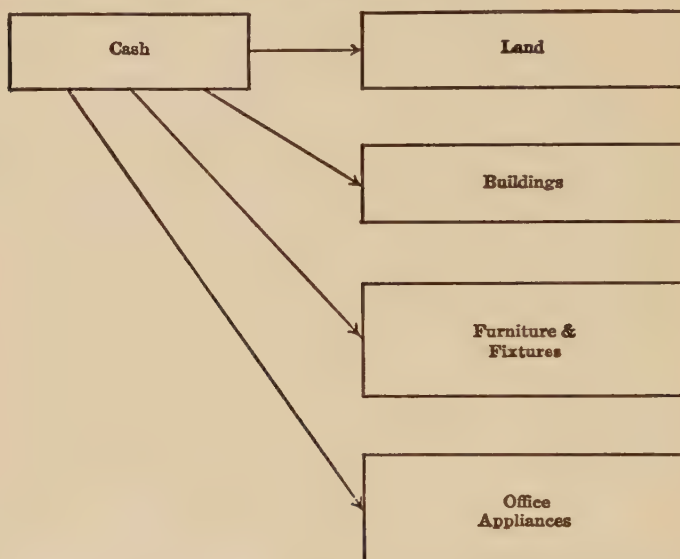


Fixed Assets. A fixed asset is one which is acquired for use in conducting the business and which in the regular course of business is not to be reconverted into cash. The distinguishing characteristics of a fixed asset are:

1. Acquisition for use as an instrument in the conduct of the business.
2. No intention in the regular course of the business to reconvert into cash.

Illustrations of fixed assets are: Land, buildings, furniture and fixtures, office appliances, etc. It should be noted

that the word *fixed* refers more to the investment in these assets than to the nature of the assets themselves, as illustrated by the following diagram.



The investment in these assets remains fixed and in the regular course of the business will not be reconverted into cash.

Deferred Charges to Profit and Loss. A deferred charge to Profit and Loss, usually called merely a *deferred charge*, or *deferred asset*, is that portion of a revenue expenditure made or incurred during a fiscal period which applies to or benefits a subsequent period.

Illustrations of deferred charges are: Prepaid insurance, prepaid interest, stationery and supplies on hand, and prepaid taxes.

Subdivision of Liabilities. Liabilities for present purposes are subdivided into *current liabilities* and *fixed liabilities*.

Current Liability. A current liability is an obligation which matures within a period of approximately one year. No absolute period of time can be fixed for classification as a current liability but it does not ordinarily exceed a year. The current liabilities are ordinarily to be paid from the current assets and the ratio of one to the other is very important.

Illustrations of current liabilities are: Accounts payable, notes payable, and drafts payable.

Fixed Liability. A fixed liability is an obligation which is not due for a period in excess of a year. This type of liability is usually secured by a lien on a specific fixed asset and is, therefore, usually not considered payable from the present current assets.

A common illustration of a fixed liability is a mortgage payable. This is nothing more than a note payable which is not due for some time and for which the debtor gives the creditor title to some real estate as security for the indebtedness.

Subdivision of Capital. The capital or the interest of the proprietor in the assets of the business may be represented by two accounts: *Proprietor's Investment* or *Capital Account* and *Proprietor's Drawing* or *Current Account*.

Proprietor's Capital Account. The Proprietor's Capital account is used to exhibit the permanent investment of the proprietor in the business. This account is credited for additional permanent investments and debited for reductions of the permanent investment through withdrawals or losses.

Proprietor's Drawing Account. The Proprietor's Drawing account is used to exhibit changes in the proprietary interest which are not intended to affect the permanent in-

vestment. This account is debited for withdrawals made by the proprietor in anticipation of profits, which are not intended as a reduction of the permanent investment. At the close of the period the balance of the Profit and Loss account is closed into this account. The balance of the Proprietor's Drawing account, if a debit, shows the extent to which the proprietor has overdrawn the profits and acts as a reduction of capital. If the balance is a credit, it shows the undrawn profits remaining in the business and acts as an increase of capital.

The balance of the Proprietor's Drawing account may be closed, at the end of the period, into the Proprietor's Capital account or it may be left open, subject to subsequent withdrawal by the proprietor. If it is left open it must be considered for balance sheet purposes as a part of the proprietor's capital.

Illustrative Balance Sheet. To illustrate the foregoing, the balance sheet of William Kent as of July 31, 19—, prepared from the working sheet illustrated in the previous chapter, is presented herewith:

(REPORT FORM OF BALANCE SHEET)

WILLIAM KENT

BALANCE SHEET, AS AT JULY 31, 19—

ASSETS

Current Assets:

Cash		\$3,950.09	
Petty Cash		66.50	
Notes Receivable		4,300.00	
Acceptances Receivable		2,800.60	
Interest Accrued on Notes Receivable		10.80	
Accounts Receivable	\$5,915.95		
Less — Reserve for Bad Debts	651.62	5,264.33	
Merchandise Inventory		8,470.50	\$24,862.82

Fixed Assets:

Furniture and Fixtures	2,840.00		
Less—Depreciation Reserve	<u>165.69</u>	2,674.31	
Office Appliances	1,600.00		
Less—Depreciation Reserve	<u>155.54</u>	<u>1,444.46</u>	4,118.77

Deferred Charges:

Prepaid Insurance		250.00	
Stationery and Supplies on Hand		160.00	
Prepaid Interest		<u>26.00</u>	436.00

Total Assets\$29,417.59

LIABILITIES AND CAPITAL

Current Liabilities:

Notes Payable	\$6,264.70	
Interest Accrued on Notes Payable	9.64	
Acceptances Payable	860.50	
Accounts Payable	7,571.10	
Taxes Accrued	<u>60.00</u>	\$14,765.94

Fixed Liabilities:

.....	xxx.xx	
.....	<u>xxx.xx</u>	xxx.xx

Total Liabilities\$14,765.94*Capital:*

William Kent — Capital	<u>14,651.65</u>
------------------------	------------------

Total Liabilities and Capital\$29,417.59

VERIFICATION OF NET WORTH

Investment 1/1/—		\$10,871.85
Add: Excess of Profits over Drawings		
Net Profit for Period	\$6,229.80	
Drawings	<u>2,450.00</u>	3,779.80
<i>Total Capital, July 31, —</i>		<u>\$14,651.65</u>

Balance Sheet — Report Form. In the report form of balance sheet, illustrated above, the current assets are shown in the first part of the asset section and the current liabilities in the first part of the liability section. This arrangement is particularly adaptable to the purposes of short-term creditors, who are interested only in the ability of the business as a “going concern” to meet its obligations. The difference between the total current assets and the total current liabilities is called the *Net Current Assets* or *Working Capital*.

The valuation accounts, Reserve for Depreciation and Reserve for Loss on Bad Debts, are shown in the report form of balance sheet as deductions from the corresponding assets.

Balance Sheet — Account Form. The account form of balance sheet, as explained previously, is a two-side form showing the assets (debit balances) on the left side and the liabilities, reserves and capital (credit balances) on the right side. In this account form of balance sheet the fixed assets and liabilities are placed first in their respective sections, thus being given the most prominent position.

This arrangement of assets and liabilities is desirable when the balance sheet is being prepared for long-term creditors who are secured by liens on the fixed assets of the business or who have made long-time loans to the business. Creditors of this type are interested in measuring the security which the excess of the fixed assets over the fixed liabilities gives them.

In this form of balance sheet the valuation accounts, inasmuch as they are credit balances, are shown with the other credit balances; namely, the liabilities and capital.

Capital Section of the Balance Sheet. As illustrated in the report form of balance sheet the capital is shown in one

amount. In the account form the detail of the changes in capital is included in the balance sheet. Either of these methods of showing capital may be used in any form of balance sheet.

The balance sheet is prepared for several purposes, sometimes for the proprietor himself, sometimes for his bank or creditors for credit purposes, and sometimes for other agencies or organizations which desire information regarding the business of the proprietor. The proprietor may not desire certain information regarding his profits and drawings to become public property. In that case he may show the capital in one amount only, as in the report form of balance sheet. In this event a separate statement showing the changes in capital is prepared for the proprietor to supplement the balance sheet.

Arrangement of Accounts in Balance Sheet. The most common order in the arrangement of accounts on a Balance Sheet is illustrated on pages 312-13. The asset accounts are arranged in order of their availability: Current, Fixed, Deferred. The liability side usually follows the arrangement on the asset side.

The arrangement on pages 316-17 shows the fixed assets and liabilities listed first.

There is no definite rule as to the order of arranging the items on a balance sheet. A logical and clear arrangement should be used; one which is readily understood by the persons reading it.

(ACCOUNT FORM OF BALANCE SHEET)

WILLIAM
BALANCE SHEET,

ASSETS

Fixed Assets:

Furniture and Fixtures	\$2,840.00	
Office Appliances	<u>1,600.00</u>	\$4,440.00

Current Assets:

Cash	3,950.09	
Petty Cash	66.50	
Notes Receivable	4,300.00	
Interest Accrued on Notes Receivable	10.80	
Acceptances Receivable	2,800.60	
Accounts Receivable	5,915.95	
Merchandise Inventory	<u>8,470.50</u>	25,514.44

Deferred Charges:

Prepaid Insurance	250.00	
Stationery and Supplies on Hand	160.00	
Prepaid Interest	<u>26.00</u>	<u>436.00</u>

Total Assets\$30,390.44

(ACCOUNT FORM OF BALANCE SHEET)

KENT

AS AT JULY 31, 19—

LIABILITIES AND CAPITAL

Fixed Liabilities:

.....	\$xxx.xx	
.....	<u>xxx.xx</u>	<u>\$xxx.xx</u>

Current Liabilities:

Notes Payable	6,264.70	
Interest Accrued on Notes Payable	9.64	
Acceptances Payable	860.50	
Accounts Payable	7,571.10	
Taxes Accrued	<u>60.00</u>	<u>14,765.94</u>

Total Liabilities 14,765.94

Reserves:

Reserve for Loss on Bad Debts	651.62	
Depreciation Reserve — Furniture and Fixtures	165.69	
Depreciation Reserve — Office Ap- pliances	<u>155.54</u>	<u>972.85</u>

Total Liabilities and Reserves 15,738.79

Capital:

William Kent — Capital		
Balance — Jan. 1	10,871.85	
Add: Net Profit 1/1-7/31	\$6,229.80	
Less: Drawings	<u>2,450.00</u>	<u>3,779.80</u>
		<u>14,651.65</u>

Total Liabilities, Reserves and Capital \$30,390.44

Contingent Liabilities. In addition to the types of liabilities already explained, there is another kind of liability known as a *contingent liability*. This is an obligation which, depending entirely upon the performance or non-performance by a person outside of the business of a future act, becomes either no liability or a real liability.

The obligation assumed by the indorser of a negotiable instrument is a contingent liability. If the maker or drawee pays the instrument at maturity, it releases the indorser from liability. If he does not pay the instrument, it becomes a real liability.

Contingent liabilities should be shown on the balance sheet in such a way that all persons interested will be apprised of their existence. A very common method of showing this type of liability is to append a statement thereof below the balance sheet as a footnote.

The contingent liabilities of William Kent as of July 31, 19—, consist of notes and acceptances indorsed and discounted amounting to \$1,910.50.

Balance Sheet Analysis. In analyzing a balance sheet some of the more important facts to be ascertained are:

1. The ratio of the current assets to the current liabilities.

This ratio indicates the margin of safety of the short-term creditors and is the most important of all the ratios. It is frequently referred to as the "Working Capital" ratio. In the past, undue emphasis has been placed on the so-called "2 to 1" ratio of current assets to current liabilities. This ratio may be too large for some types of business and too low for other types. The ratio should be large enough so that even in case of unusual shrinkage in the assets the creditors would still be covered.

2. The ratio of average monthly sales to the balance of the accounts receivable.

The object of this ratio, for a business which has a credit period of a month, is to determine the extent to which the customers are paying their bills within the credit period. If the balance of the accounts receivable are two or three times the average monthly sales, it indicates that the customers are taking two or three months to pay their bills.

3. The ratio of the merchandise inventory to the total current assets.

The merchandise inventory is the one asset most likely to shrink in value. Consequently, the ratio of the inventory value to the total current assets is most important in determining the margin of safety.

4. The ratio of the total liabilities to the total capital of the proprietor.

The creditors are interested in the ratio of the investment of the proprietor to their claims on the business. Many banks insist rigidly that the proprietor's risk in a single proprietorship shall be considerably greater than the risk of the creditors.

Reference is frequently made to "Borrowed Capital," and "Owned Capital." The liabilities represent this borrowed capital and the "Capital" represents owned capital. It is evident that the creditors would not enjoy the thought that they are furnishing the greater part of the capital for a proprietor of a business.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Define and explain the subclassification of assets.
2. Current assets are known by what other names?

3. Explain the distinction between current and fixed assets. Illustrate.
4. Explain how an expense item may be treated as an asset.
5. Name and explain the subdivisions of liabilities.
6. Through the use of a skeleton ledger account, list all the debits and credits to the Capital account.
7. Explain the use of the Proprietor's Drawing account.
8. Show in skeleton form the arrangement of the balance sheet.
9. Explain the difference between the report form and the account form of balance sheet.
10. When would you show the capital of the proprietor in one amount and when would you show details as to net profit and previous capital balance?
11. Define a contingent liability.
12. How may a contingent liability be shown on a balance sheet?
13. List the important facts that can be learned from a balance sheet.
14. What persons are interested in the balance sheet of a business?
15. Explain the four balance sheet ratios.

CHAPTER XX

THE PROFIT AND LOSS STATEMENT — REVERSING ENTRIES

Purpose of Profit and Loss Statement. The purpose of the Profit and Loss Statement, as stated previously, is to furnish the details of the increase or decrease of proprietorship for the period as reflected in the balance sheet at the close of the period. It is a statistical statement supporting and supplementing the balance sheet and consequently it must be so prepared that it will serve as an adequate basis for judging the results of the operation of the business for the period.

Subdivisions of Income. The income of a business may be broadly classified into the following two classes:

1. Operating Income
2. Non-operating Income

Operating Income. The *operating income* is the income naturally accruing from the performance of the real function of the business. Thus, the operating income of a commission business is the commission earned by selling for others. The operating income of a trading business is the profit resulting from selling the merchandise of the business for more than it cost.

Non-operating Income. The *non-operating income*, also called *other income*, is the income arising from any source other than the principal function of the business. This type of income is sometimes called *financial income* and also *extraneous income*. Illustrations of non-operating income in

a trading business are interest income and discount on purchases. This income comes from the employment of capital and not from the buying and selling of merchandise.

Subdivisions of Expense. The expenses of a business may be broadly classified into:

1. Operating Expenses
2. Non-operating Expenses

Operating Expenses. The *operating expenses* are those which are necessary for the conduct of the business. They are those which are incurred in the performance of the principal function of the business. The operating expenses are the ordinary and regular expenditures made to produce the operating income. Illustrations of this type of expenses are: Salaries of employees, rent, telephone and telegraph, depreciation of equipment, etc.

Non-operating Expenses. The *non-operating expenses* are those expenses which are incidental only to the operation of the business. This type of expense includes the extraordinary expenses or losses incurred within a year as well as expenses which, while not really extraordinary, are extraneous to the principal function of the business. Illustrations of expenses which may be classified as non-operating expenses or other charges are: Interest expense, discount on sales, loss from bad debts, loss on the sale of fixed assets, etc.

Form of Profit and Loss Statement. In preparing a Profit and Loss Statement the operating income and expenses are shown separately from the non-operating income and expense by dividing the statement into two major sections, namely, Operating Section and Non-operating Section. The Operating Section is subdivided into two divisions called the *Trading Section* and the *Operating Expense*

Section; the Non-operating Section is also divided into the *Other Income* and *Other Expense Sections*.

The object of the Operating Section of the statement is to exhibit the profit or loss derived from the principal activity of the business. The principal activity of a trading business is the buying and selling of merchandise and the first major section shows the result of carrying on this activity. The Trading Section shows the excess of the selling price over the cost price of the goods sold (the gross profit) and the Operating Expense Section shows the expenses incurred in producing the gross profit.

The Non-operating Section shows the income and expenses extraneous to the main function of the business. This section is frequently called the financial section because it is largely composed of financial income and expense items.

The Profit and Loss Statement is thus arranged so as to show a net profit or loss from the actual operations of the business, and a final net profit or loss from the business as a whole.

The form of Profit and Loss Statement illustrated on page 324 is a fairly standard outline for the operating statement of an average trading business. The form is elastic, however, and may be expanded or condensed to fit the accounts used in any particular business. As business expands and enlarges and operations become more and more complicated, the Nominal group of accounts is expanded and analyzed much more in detail than the Real Account group.

There is no definite form to which all Profit and Loss Statements must conform. Any arrangement of the items or the sections that furnishes the information desired by the management, in readable form, is satisfactory.

The following Profit and Loss Statement, showing percentages, exhibits the results of the operation of the business of William Kent for the seven months ending July 31, 19—:

WILLIAM KENT

PROFIT AND LOSS STATEMENT FOR THE PERIOD JANUARY 1 TO JULY 31, 19—

		% Analysis
Gross Sales	\$65,422.45	
Less — Sales Returns and Allowances	<u>260.10</u>	
Net Sales	\$65,162.35	100%
Deduct — Cost of Goods Sold:		
Inventory 1/1—	6,870.65	
Purchases	\$44,032.30	
Add — Freight, Expense, and Cartage In	<u>593.30</u>	
Cost of Gross Purchases	44,625.60	
Less — Purchases, Returns and Allowances	<u>600.00</u>	
Cost of Net Purchases	44,025.60	
Total Cost of Goods for Period	50,896.25	
Less — Inventory 7/1—	<u>8,470.50</u>	
	42,425.75	(1) .651
Gross Profit for the Period	22,736.60	(2) .349
Deduct — Operating Expenses:		
Salaries	7,600.00	(3) .116
Rent	4,200.00	(4) .062
Stationery and Supplies	57.10	(5) .00087
Telephone and Telegrams	135.30	(6) .002
Insurance	50.00	(7) .00076
Traveling Expense	2,056.30	(8) .031
Advertising	820.00	(9) .0125
General Expense	470.60	(10) .0072
Depreciation on Office Appliances	155.54	(11) .0023
Depreciation on Furniture and Fixtures	165.69	(12) .0025
Taxes	<u>60.00</u>	(13) .0009
	15,770.53	(14) .242
Net Operating Profit for the Period	6,966.07	(15) .1069
Add — Other Income:		
Discount on Purchases	854.91	
Interest Income	<u>172.05</u>	1,026.96
Total Income for the Period	7,993.03	
Less — Other Expenses:		
Interest Expense	259.88	
Discount on Sales	851.73	
Estimated Loss on Accounts Receivable	<u>651.62</u>	1,763.23
Net Profit for the Period	<u>\$6,229.80</u>	(16) .0956

Use of Percentage in Analyzing Profit and Loss Statement. The relationship of the various items on the profit and loss statement to one another may best be shown by the use of percentages. Net sales for certain comparisons is commonly considered unity or 100 per cent and the related items are reduced to a per cent of this base.

The comparisons made with Net Sales on the Profit and Loss Statement of William Kent are as follows:

1.	<u>Cost of Goods Sold</u>	=	42,425.75	=	.651
	Net Sales		65,162.35		
2.	<u>Gross Profit</u>	=	22,736.60	=	.349
	Net Sales		65,162.35		
3.	<u>Salaries</u>	=	7,600.00	=	.116
	Net Sales		65,162.35		
4.	<u>Rent</u>	=	4,200.00	=	.062
	Net Sales		65,162.35		
5.	<u>Stationery & Supplies</u>	=	57.10	=	.00087
	Net Sales		65,162.35		
6.	<u>Telephone & Telegrams</u>	=	135.30	=	.002
	Net Sales		65,162.35		
7.	<u>Insurance</u>	=	50.00	=	.00076
	Net Sales		65,162.35		
8.	<u>Traveling Expenses</u>	=	2,056.30	=	.031
	Net Sales		65,162.35		
9.	<u>Advertising</u>	=	820.00	=	.0125
	Net Sales		65,162.35		
10.	<u>General Expense</u>	=	470.60	=	.0072
	Net Sales		65,162.35		
11.	<u>Deprec. on Off. Appl.</u>	=	155.54	=	.0023
	Net Sales		65,162.35		
12.	<u>Deprec. on Fur. & Fixt.</u>	=	165.69	=	.0025
	Net Sales		65,162.35		
13.	<u>Taxes</u>	=	60.00	=	.0009
	Net Sales		65,162.35		
14.	<u>Total Operating Exp.</u>	=	15,770.53	=	.242
	Net Sales		65,162.35		
15.	<u>Net Operating Profit</u>	=	6,966.07	=	.1069
	Net Sales		65,162.35		
16.	<u>Net Profit</u>	=	6,229.80	=	.0956
	Net Sales		65,162.35		

These percentages may be used to construct a statement showing in terms of one dollar the composition of each dollar of sales.

Net Sales	\$1.00
Deduct — Cost of Goods Sold	<u>.651</u>
Gross Profit	.349

Deduct — Operating Expenses:

Salaries	.116	
Rent	.062	
Stationery and Supplies	.00087	
Telephone and Telegrams	.002	
Insurance	.00076	
Traveling Expense	.031	
Advertising	.0125	
General Expense	.0072	
Depreciation on Office Appliances	.0023	
Depreciation on Furniture and Fixtures	.0025	
Taxes	<u>.0009</u>	<u>.242</u>
Net Operating Profit per Dollar of Sales		<u>.107</u>

This statement brings out very clearly the relationship of each operating item on the Profit and Loss Statement with the Net Sales. The "Other Charges" and the "Other Income" bear no relationship to the net sales and consequently are not compared with it.

The final comparison made from the Profit and Loss Statement is that of the net profit for the period with the investment of the proprietor. This may be expressed as follows:

$$\frac{\text{Net Profit for Period}}{\text{Investment for Period}} = \frac{6,229.80}{10,871.85} = 57.3\%$$

The per cent of net profit to investment is large but is not exorbitant considering that the proprietor has devoted

his time and services to the business and has not received any salary.

Advantages of Percentage Analysis. Percentages show a relationship to a definite unit and are easily remembered and understood. By comparing the percentages in statements for consecutive periods, a proprietor may notice tendencies of items which he would not otherwise notice. He can then make inquiry and find out the reason for any marked differences in items on the statement.

For example, Mr. Kent, according to his statement, is operating on a gross profit of 34.9 per cent, or approximately 35 per cent. Suppose the next period his percentage was 30 per cent. He should immediately be interested to find out what has caused this difference. If his mark-up ratio was the same for each period, this difference might indicate errors in the inventory or if no error is found in the inventory, it might indicate that goods are being taken from his stock by employees or others. It may also indicate dishonesty in that clerks may have been appropriating cash received from sales.

This type of analysis may produce much more efficiency in the business and also induce better business policies, which will result in producing more income for the owner of the enterprise.

REVERSING ENTRIES

Real Accounts Resulting from Adjustments. The adjusting entries made at the close of a period to reflect certain income and expense values in the Profit and Loss Statement create real accounts of a temporary character. They are brought into the records in order to show as accurate a condition of the business as possible. These accounts were opened merely to record certain assets and liabilities which

were not recorded during the period through the routine bookkeeping procedure. Illustrations of such accounts are Interest Accrued on Notes Receivable, Interest Accrued on Notes Payable, Salaries and Wages Accrued, Taxes Accrued, Prepaid Interest, Prepaid Insurance, Stationery and Supplies on Hand and Merchandise Inventory.

Having served their purpose, these accounts may be allowed to remain open on the Ledger during the next period or they may be disposed of by the following methods:

1. By allowing these accounts to remain open and gradually closing them during the following period by making an entry each time a transaction occurs, recording that portion of the transaction, which represents the adjustment at the end of the prior period, as a debit or credit to the real account, and recording the remaining part of the transaction, which applies to the new period, as a debit or credit to the proper nominal account. This method is called the *Split Method*.
2. By closing the real accounts created by prior period adjustments at the beginning of the new period by means of Journal entries. This method is known as the *Reversing Method*. The entries made are called *reversing entries*.

The Split Method. The *split method* is so called because each entry made during the new period, for a transaction which affects the accounts mentioned, is divided into parts. One part is recorded as affecting the real account created by the adjustment at the end of the prior period and the other part as affecting a nominal account of the new period.

To illustrate: On July 31, 19—, the interest accrued on H. H. Hall's note amounting to \$8.40 and on N. O. Dolan's note amounting to \$2.40 was brought on to William Kent's books as an asset and credited to the income for the period

ending July 31, 19—. These two notes fall due during the next accounting period and when the notes are paid the interest for the full time is paid as well.

That portion of the interest on these notes which was accrued to July 31, 19—, has already been recorded as an asset and credited as income. Therefore, only that portion of the interest received which has been earned since July 31, 19—, should be considered income for this new period. In other words, from the total interest received when the note is paid, the interest accrued at the close of the previous period must be subtracted in order to obtain the amount of the interest earned in this new period.

The following entry would be made on the date when H. H. Hall's note was paid:

August 9, 19—

Cash	12.00	
Interest Accrued on Notes Receivable		8.40
Interest Income		3.60
To record interest received on		
H. H. Hall's note. Face of note		
\$2,400; time, 30 days; interest		
\$12.00.		

The above entry writes off from the Interest Accrued on Notes Receivable account that part of the interest on H. H. Hall's note which was accrued to July 31, 19—, and records the income earned in this period in the Interest Income account.

Under this plan these real accounts created by adjustments are allowed to remain open on the books and are gradually written off in the new period by separate entries each time a transaction occurs affecting them.

This method of accounting for the information brought on the books by adjustments requires a close scrutiny of

many transactions during the new period in order to determine whether any portion of them has already been recorded through the adjustments of the prior period. Such an examination of transactions would require a great deal of time and careful analysis. In the present day, with the large volume of business and the subdivision of accounting labor, it would be impracticable, and this method, therefore, is not recommended.

The Reversing Method. In the *reversing method* the real accounts created by adjustments, which are not to be used in recording regular transactions of the new period, are closed by means of Journal entries called *reversing entries*. These entries are so called because they reverse the corresponding adjusting entries made at the close of the prior period.

Under this method the following entry would be made to close the Interest Accrued on Notes Receivable account on the books of William Kent:

August 1, 19—		
Interest Income	10.80	
Interest Accrued on Notes Receivable		10.80
To reverse the entry made July 31, 19—, which recorded the accrued interest on the notes receivable as of that date, thereby closing the Accrued account.		

It should be observed in the reversing entry illustrated above that the income account, Interest Income, is debited for the interest accrued as of July 31, 19—. As payment is received for the interest during the period following July 31, 19—, no analysis is required of the interest received, the entire amount being credited to Interest Income account.

The debit referred to above automatically subtracts from this income account the interest accrued at the close of the prior period, which was credited to the income account for that period.

At the end of the following period the only account to appear on the trial balance, of the two used above, would be the Interest Income account.

The Interest Income account of William Kent for the month of August is illustrated as follows:

Interest Income			
19—	19—		
Aug. 1 (Reversing Entry) 10.80	Aug. 9		12.00
	" 13		4.50
	" 25		6.40
	" 31	<i>37.90</i>	<i>15.00</i>
		<i>10.80</i>	
		<i>27.10</i>	<i>37.90</i>

The balance of this account, \$27.10, shows the amount of the interest collected in August which is income for that month.

Reversing Entries of William Kent. The following are the remainder of the reversing entries for the William Kent business made as of August 1, 19—:

2.* Entry made to reverse the adjustment for interest accrued on notes payable:

August 1, 19—		
Interest Accrued on Notes Payable	9.64	
Interest Expense		9.64

To reverse entry made July 31, 19—, recording interest accrued on notes payable to that date, thereby closing the Accrued account.

* Reversing Entry No. 1 is illustrated on page 330.

3. Entry made to reverse the adjustment for interest paid on notes payable discounted:

August 1, 19—		
Interest Expense	26.00	
Prepaid Interest		26.00

To reverse adjustment made July 31, recording interest paid in advance on notes payable discounted.

4. Entry made to reverse the adjustment for prepaid insurance:

August 1, 19—		
Insurance	250.00	
Prepaid Insurance		250.00

To reverse adjustment made July 31, 19—.

5. Entry made to reverse the adjustment for stationery and supplies unused:

August 1, 19—		
Stationery and Supplies	160.00	
Stationery and Supplies on Hand		160.00

To reverse adjustment made July 31, 19—.

Reversing Entry for Merchandise Inventory. A reversing entry for the merchandise inventory may be made at the beginning of the period or the amount of the inventory may be left in the Inventory account until the end of the period and then merged with Purchases.

As frequent reference is made to the inventory during the year and as it is used in the Profit and Loss Statement, it seems to be the better practice to allow the Merchandise Inventory account to remain open during the year. This

old balance of inventory will then appear on a trial balance taken at the end of a period.

Adjustment Accounts Allowed to Remain Open for Entire Succeeding Period. When adjustment accounts are allowed to remain open until the next adjustment period they may be handled as follows:

- A. By making reversing entries to close them into the nominal accounts and then make the usual adjustments for the new amounts.
- B. By making new adjustment entries to correct these real account balances so that they will record the proper adjustment balances at the end of this new period.

The interest accrued on notes receivable of the William Kent exercise is used to illustrate the above methods.

The interest accrued on notes receivable as of July 31, 19—, is \$10.80 and is reflected in the account as follows:

Interest Accrued on Notes Receivable

19—	
July 31	10.80

During August this account remains open and no entries are made in it. All entries for interest income are made in the Interest Income account, as follows:

Interest Income

	19—	
	Aug. 9	12.00
	“ 13	4.50
	“ 25	6.40
	“ 31	15.00
	(37.90)	

Method A. At the end of August there is accrued interest on notes receivable on hand of \$8.70. In making the adjustment for this account under Method A the following entries may be made:

(1)

August 31, 19—

Interest Income	10.80	
Interest Accrued on Notes Receivable		10.80
To reverse the adjustment of July 31, 19—, for the interest accrued on that date.		

(2)

August 31, 19—

Interest Accrued on Notes Receivable	8.70	
Interest Income		8.70

To set up accrued interest on notes receivable on hand August 31, 19—.

J. A. Murray — \$1,250 —

26 days — \$6.42

W. D. Polley — 620 —

22 days — 2.28

After posting these entries the accounts illustrated above would appear as follows:

Interest Accrued on Notes Receivable				Interest Income			
19—		19—		19—		19—	
July 31	10.80	Aug. 31	(1) 10.80	Aug. 31	(1) 10.80	Aug. 9	12.00
19—						" 13	4.50
Aug. 31	(2) 8.70					" 25	6.40
						" 31	15.00
						" 31 (2)	8.70

The balance of the Interest Accrued on Notes Receivable account now shows the accrued value August 31, and is an asset. The Interest Income account now reflects the income earned during August.

Method B. The entry under Method B is as follows:

August 31, 19—

Interest Income	2.10	
Interest Accrued on Notes Receivable		2.10
To adjust the interest accrued on August 31 to the correct figure.		
Interest accrued July 31	\$10.80	
Interest accrued August 31	8.70	
Reduction in accrual	2.10	

If the interest accrued on August 31 were greater than on July 31, the above entry would be in reverse form for the amount of the increase.

After posting the above entry the two accounts affected would appear as follows:

Interest Accrued on Notes Receivable		Interest Income			
19—	19—	19—	19—		
July 31	10.80	Aug. 31 (1)	2.10	Aug. 9	12.00
				" 13	4.50
				" 25	6.40
				" 31	15.00

The balance of each account is the same as in Method A.

In Method A the entries, as illustrated, are always made in the same manner. In Method B the entry illustrated would be used when the amount accrued is less than the previous accrual and in reverse form when the new accrual is the greater.

There are certain occasions in practical accounting for using any or all of the methods illustrated in this chapter. Under certain circumstances one method would be advisable, under other circumstances another method.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. What is the purpose of the Profit and Loss Statement?
2. What is the effect of subdividing the Profit and Loss Statement into sections?
3. Name the sections as illustrated in this chapter in their proper order.
4. Give in detail the content of each section.
5. Explain how a percentage analysis of the Profit and Loss Statement is accomplished.
6. What advantages accrue from the percentage analysis?
7. Name some of the real accounts created by adjusting entries.
8. Explain the procedure of accounting for these accounts.
9. Explain the *split method* of accounting for certain real and nominal accounts.
10. What is a reversing entry?
11. What is the effect of making a reversing entry at the beginning of the period instead of at the end of the period?
12. Illustrate by using the Interest Accrued on Notes Payable account the *split method*; the *reversing method*.
13. How is it possible to tell by looking at the trial balance accounts what has been done to the real accounts created by adjustments?
14. Explain the methods of handling these real accounts created by adjustments when they are allowed to remain open until the end of the period.

CHAPTER XXI

DEPARTMENTALIZATION

Necessity for Departmentalization. In a business in which more than one class of merchandise is marketed, it is important to learn the results of trading in the different classes of goods. It frequently happens that one or more departments are quite profitable while others may be actually operated at no profit or even at a loss. Again, the sales effort required to sell goods of one department may far outweigh the profits realized.

The accounting department renders important service to the management by revealing the results of the operation of each department of the business and in prorating the expense of securing these results in such a way that conclusions may be reached as to the advisability of discontinuing the operation of any department. In recent years, due to expansion and competition of modern business, the management has demanded more and more information regarding the operation of each phase of a business, and the accountants, to meet this demand, have developed highly scientific accounting systems based on carefully selected account classifications.

Subdivision of Trading Accounts. To obtain the gross profit for each department it is necessary to segregate the sales, purchases, and inventory of the goods handled in each department. This segregation may be accomplished by any of the following methods:

I. *Departmental Trading Accounts.* The opening of a separate Sales, Sales Returns, Purchases, Purchases Returns,

Date		Explanation	F	Ledger Columns		Distribution							
				Debit		Credit		Dept. A		Dept. B		Dept. C	

Date		Explanation	F	Ledger Columns				Distribution							
				Debit		Credit		Dept. A		Dept. B		Dept. C			

INVENTORY

Date		Explanation	F		Date		Explanation	F	
		Dept. A \$xxxx Dept. B \$xxxx Dept. C \$xxxx		xxxx xx					

The standard form of Ledger sheet is used for this account to provide for the closing of the beginning inventory and the entry for the closing inventory. The amounts of the individual inventories are entered in the Explanation column

and the total inventory amount in the Debit amount column. When this inventory is closed out, the same procedure is followed in the credit column.

III. *Separate Analysis of Ledger Trading Accounts.* The maintaining of general trading accounts for Sales, Purchases, Sales Returns, and Purchases Returns in the General Ledger and analyzing these accounts on analysis sheets, separate from the accounts. A sheet for each of the trading accounts would be used on which columns would be provided for analysis of the department amounts. No illustrations of these sheets need be given, as they would be similar to those illustrated for method Number II.

Consideration of the Methods. The first and second methods would be entirely satisfactory in a business in which there were relatively few departments, but would be entirely impracticable in a business that had many different departments. In such a case the third method, in which the general trading accounts are kept in the General Ledger, and analyzed on subsidiary sheets, would be used. This would permit the necessary subdivision of work for the daily recording and analysis of the transactions. Method Number I is used in the illustrated laboratory set.

Freight and Express Inward. The freight and express paid on the goods purchased may be distributed to the departments by either of the following methods:

- (1) By analyzing each bill and charging each department with its own freight and express.
- (2) By prorating the total amount paid during the period to the departments in the ratio of the purchases of the departments to the total purchases.

The first method is preferable from the viewpoint of accuracy and should be used whenever it is practicable.

The second method is simple and gives satisfactory results when the ratio of the freight cost to the dollar value of the goods purchased is fairly uniform in all the departments.

If the first method is used, each bill is charged directly to the Departmental Purchases account when received, thus making it unnecessary to keep a Freight and Express Inward account. If the second method is used, the freight bills as received are charged to the Freight and Express Inward account, and the total of this account at the close of the period is prorated to the departments in the ratio of the departmental purchases to the total purchases for the period.

Changes in Books of Original Entry in Departmentalized Business. The books of original entry are changed to provide for the recording and accumulation of the information regarding each department. These changes in no manner affect the basic principle of recording transactions, but are rather further developments of the principles previously discussed in the chapter on subdivisions of the General Journal.

Special columns are added to the Special Journals in which the transactions affecting the departments are analyzed and accumulated. These columns are analysis columns only, and should present no difficult accounting problems.

Inasmuch as the General Journal has been subdivided and is used only for the more unusual transactions, no change in form is necessary for a departmentalized business. The so-called Special Journals are changed to record the information concerning the departments in the most efficient manner. The changes in these Journals are illustrated and explained in the following paragraphs.

Invoice Register. Previously in this text, a Purchases Journal was used to record the purchases of goods bought for the purpose of selling again at a profit. Purchases of assets and bills for expenses of various kinds were entered either in the General Journal, if purchased on credit, or in the Cash Journal, if paid for in cash.

A book, called the Invoice Register, is very frequently used to record all bills or invoices received by a business for merchandise, services, expenses, and assets. This book provides a permanent record for each and every incoming invoice and it also distributes these amounts to the proper accounts.

The form of an Invoice Register is shown on page 345.

All invoices for purchases on credit of merchandise, assets, or expenses are entered in this book and distributed into the proper columns. The amount of each invoice is entered in the first money column; the individual amounts entered in this column are posted separately to the proper creditors' accounts in the subsidiary Ledger. The total amount of this column is posted at the end of the month to the credit of the controlling account, Accounts Payable.

If the invoice covers merchandise, the amount is extended into one of the purchases columns headed respectively, Dept. A, Dept. B, Dept. C. The amounts entered in these columns are not posted individually, but the total of each column is posted at the end of the month to the debit of the proper Purchases account in the General Ledger.

Bills for freight and express inward are entered in the Invoice Register as received, the amount being placed in the Accounts Payable column, and then extended into the Departmental Purchases columns according to the department to which the bill belongs.

Invoices covering expenses and purchases of fixed assets

are entered in the Accounts Payable column, and extended to the Sundry columns, in which the account to be debited is written, and the amount to be debited is entered in the money column of this section. These items are posted individually to the proper accounts in the General Ledger.

This record may be expanded by the addition of special columns for expenses or other items which occur frequently. The form illustrated on page 345 is used in the practice set, as it is sufficient at this time to show the development of this record.

Cash Purchases. Occasionally purchases of merchandise are made for cash from persons with whom regular accounts are not to be opened. Such purchases may be entered in the Invoice Register in the same manner as regular purchases on credit, the amount being entered in the Accounts Payable column and in the proper Departmental Purchases column. No individual posting is made of such amounts, but they are checked to indicate that they are not to be posted.

The corresponding payment of cash is entered in the Cash Disbursements Book in the Accounts Payable column. This item is not posted, but is checked in a similar manner to the corresponding amount in the Invoice Register.

If there were numerous purchases for cash, a special column for cash purchases may be provided in the Invoice Register. The amounts of such purchases would be entered in the Cash Purchases column and extended into the proper Department Purchases columns. A Cash Purchases column would also be provided in the Cash Payments Book and the same amounts entered as in the Invoice Register. No individual postings are made from the Cash Purchases columns of either the Invoice Register or the Cash Book,

nor is it necessary to post the totals at the end of the month. These columns are maintained primarily to make these books self-balancing.

Certain cash payments for petty cash, notes payable, salaries and wages paid, drawings by proprietor, etc., are to be entered only in the Cash Payments Journal. No entry is made in the Invoice Register for these items, as no account is to be kept in the Creditors' Ledger for any of the above.

Sales Book. The Sales Book is expanded to provide for the analysis of the sales by each department. A form of Sales Book is illustrated on page 345.

The sales to regular customers who buy on credit are entered in the Accounts Receivable column and extended into the proper Department Sales column. The amounts in the Accounts Receivable column are posted individually to the customers' accounts and the total of this column is posted at the close of the month to the controlling account, Accounts Receivable.

The various Department Sales columns are posted at the end of the month to the proper Department Sales accounts.

A Cash Sales column is provided in this book, because in almost every business sales are made to persons with whom regular accounts are not to be opened. The amounts of such sales are entered in the Cash Sales column and extended into the Department Sales columns in the same manner as charge sales. No postings need be made from the Cash Sales column either individually or in total.

A corresponding column is kept in the Cash Receipts Book, which will be explained later. The Cash Sales column of the Sales Book will equal at all times the Cash Sales column in the Cash Book. The Sales Book entries

are made from the duplicate sales slips daily, and the Cash Book entries are made from the Cash proof sheet daily. Frequently one person enters the sales and another handles the cash. This provides a very desirable check on the work of these two persons.

Cash Receipts Journal. The only change in the Cash Receipts Journal is the addition of a column to record the amount of the cash sales. Receipts from sales made for cash are entered in this column and the Cash Receipts column. The amounts entered in the Cash Sales column are not posted. This column should agree with the Cash Sales column of the Sales Journal. A form of Cash Receipts Journal with a Cash Sales column is illustrated on page 348.

Cash Disbursements Journal. This Journal contains four money columns, as illustrated on page 348. All payments for invoices which have been recorded in the Invoice Register are entered in the Accounts Payable column of this Journal. Payments of cash for items not previously recorded in the Invoice Register are entered in the General Ledger column. Each and every payment of cash is recorded in the Cash Paid column for the amount of the check. If there is a cash discount allowed, the amount of the discount is entered in the Discount on Purchases column, the amount of the check in the Cash Paid column, and the sum of these two entries is entered in the Accounts Payable column or General Ledger column.

The posting of the Cash Journals is the same as explained in Chapter XIII, Part I.

Petty Cash. The Petty Cash Journal is used for cash disbursements which are paid in currency. A form is illustrated on page 348.

This class of transactions is removed from the Cash

Payments Journal and recorded in a separate journal. The amount of each petty cash voucher is entered in the Petty Cash Credit column and extended into one of the special columns or entered in the Sundry Debits column.

The posting of this journal has been explained in Chapter XIV, Part I.

The columns at the left of the form, for Cash Received and Balance, are inserted only for convenience in proving and balancing the Petty Cash fund. No posting is necessary from either of these columns.

Method of Handling Cash in this Exercise. All cash received is recorded in the Cash Receipts Journal and deposited in the bank daily, or as frequently as possible. All cash payments are made by check and recorded in the Cash Disbursements Journal. The balance of the Cash account will at all times agree with or may be easily reconciled with the Bank account.

The Petty Cash fund is established by drawing a check to the order of "Petty Cash." This check is then cashed and the money placed in the safe or cash box. A separate cash account is thereby established, called Petty Cash, and a separate journal is used to record all transactions from this fund. The Petty Cash account is an asset account and is debited with the amount of all checks drawn and credited for all payments made. The Balance represents the amount of cash on hand and is verified by actual count at frequent intervals.

WILLIAM JONES

EXHIBIT B, SCHEDULE 1 *

Cost of Goods Sold for the Six Months Ending June 30, 19—

	Dept. A		Dept. B		Dept. C		Total	
Inventory, Jan. 1, 19—	12,000	00	25,000	00	3,000	00	40,000	00
Purchases, net	40,000	00	100,000	00	20,000	00	160,000	00
Freight In	1,000	00	2,500	00	500	00	4,000	00
Total Cost of Goods	53,000	00	127,500	00	23,500	00	204,000	00
Less: Inventory, June 30, 19—	12,000	00	52,000	00	6,600	00	70,600	00
Cost of Goods Sold	41,000	00	75,500	00	16,900	00	133,400	00

* The principal statements of business are the Balance Sheet and the Profit and Loss Statement. These statements are usually called Exhibits; the Balance Sheet because of its importance is marked Exhibit A, and the Profit and Loss Statement is marked Exhibit B. Statements which supply the details of items on the Exhibits are called Schedules. The Cost of Goods Sold Statement illustrated above is a schedule and furnishes the details of the Cost of Goods Sold which is shown on the Profit and Loss Statement.

Balance Sheet in Departmentalized Business. There is no change in the balance sheet for a business which is divided into departments. There may be a merchandise inventory shown for each department, instead of in one amount. Except for this possible change, the balance sheet-form is the same as for any trading business. The departmental plan necessitates an analysis of the operations of the business, and thereby causes a development and change principally in the Operating or Profit and Loss Statement.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. What advantage is there in obtaining statements concerning the operation of various departments of a business?
2. How can the accounting department assist the management in this regard?

3. Name some records which furnish information regarding departmental operations of a business.
4. What should be done in order to make it possible to obtain information concerning the departments of a business?
5. How may the trading accounts be subdivided?
6. Why is it necessary to subdivide the trading accounts?
7. Explain the handling of the Invoice Register. What advantages has it over the Purchases Journal?
8. Explain the method of handling cash sales in a departmentalized business.
9. Discuss the method of preparing the Cost of Sales Schedule.
10. How does the preparation of this Schedule affect the Profit and Loss Statement?
11. Explain how the gross profit by departments is determined.
12. Is departmentalization very prevalent in modern business?
13. Explain the methods of handling freight and express on incoming merchandise.
14. State certain questions a manager would probably ask concerning the operation of the various departments of his business.
15. State what accounts you would keep in the General Ledger to make it possible to prepare a departmental Profit and Loss Statement.
16. Into what departments would you divide the following common types of businesses:
 - Drug Store
 - Office Supply Business
 - Men's Furnishing Business
 - Dry Goods Store
 - Retail Furniture Business
 - Retail Shoe Business
17. Explain the method of handling cash in the average trading business.

CHAPTER XXII

EXPENSE CLASSIFICATION AND DISTRIBUTION

Methods of Expense Classification and Distribution. The following methods of classification and distribution of operating expenses are used in business:

1. Direct or actual expense classification.
2. Functional expense classification and distribution.
3. Departmental expense classification and distribution.

The classification of expense accounts depends upon the extent and kind of information desired by the management.

Generally very little attempt is made to classify the expense accounts beyond the direct or actual expense classification. The logical thing to do is to charge the expense under the name of the account which represents the value received. For example, Rent, Salaries, Insurance, Taxes, Interest, Supplies, Telephone and Telegraph, etc., are customary account titles for expenses.

This direct classification of expenses has been used thus far in this text. The functional and departmental classification and distribution will be introduced in this chapter.

Functional Classification of Operating Expenses. Heretofore expenses have been classified into two major divisions — Operating Expenses and Non-operating Expenses frequently called Other Charges. The expenses included in the classification Operating Expenses are the necessary expenses of carrying on the business, and may be further classified, based upon their function, into Buying Expenses, Selling Expenses, and Administrative Expenses.

Buying expense includes all the expenses of buying, receiving, and storing of merchandise which is to be resold.

The principal items of expense under this classification are salaries of buyers and assistants, stationery and supplies used in this department, depreciation of the departmental furniture and equipment, and a portion of the rent, taxes, light, insurance, and other general expenses.

Selling expense includes all the expenses of obtaining distribution of the merchandise. The principal items of selling expense, in addition to those which are common to both the buying and the administrative, are commissions paid salesmen, traveling expense, advertising, and delivery expense.

Administrative expense includes all the expenses of the administration or management of the business. The following chart of accounts gives in tabular form some of the more common expenses under each of the functional expense classifications:

Buying Expenses	Selling Expenses	Administrative Expenses
Salaries, Buyers, etc. Stationery and Supplies Postage Telephone and Telegraph Rent Light Depreciation of Furniture and Equipment Insurance Taxes (Property) Sundry Expenses	Salaries, Salesmen Stationery and Supplies Postage Telephone and Telegraph Rent Light Depreciation of Furniture and Equipment Insurance Taxes (Property) Advertising Traveling Expense Commissions Delivery Expense Sundry Expense	Salaries, Office and General Stationery and Supplies Postage Telephone and Telegraph Rent Light Depreciation of Furniture and Equipment Insurance Taxes (Property) Sundry Expense

It is obvious, from the above chart, that most of the accounts under each classification are similar, differing only in the type of activity which receives the benefit of the

expenditure. In the Selling Expense column, as mentioned previously, there are several accounts which are peculiar to this classification and are usually chargeable in their entirety to selling.

Methods of Accumulating Expense Items by Functional Classifications. Expenditures chargeable to the various accounts of the functional classifications may be accumulated by any of the following methods:

I. By keeping the accounts under the direct classification in the General Ledger and then at the close of the period analyzing these accounts by classification on analysis sheets. By this method there would be only one account for Salaries, Stationery and Supplies, Postage, etc., in the Ledger. Then periodically, monthly if desired, each of the accounts containing charges affecting more than one classification may be analyzed as illustrated in the following model:

SALARIES, ANALYSIS FOR THE PERIOD.....19—

	Date of Payment	Amount of Payment		Distributed					
				Buying Expense		Selling Expense		Admin. Expense	
									
		18,400 —		4,900 —		6,000 —		7,500 —	

Each item is posted from the book of original entry to the Debit Amount column and then distributed into the Distribution columns in accordance with the amount chargeable to each classification. Credits to this account are posted from the books of original entry to the Credit Amount column, and then, inasmuch as there are no credit distribution columns, they are entered in *red ink* in the Distribution columns. Credits to expense accounts rarely occur, so that credit entries would be very few.

III. By keeping the individual account with each direct classification in the General Ledger and distinguishing similar accounts by writing after them the name of the functional classification. The accounts for salaries paid would appear as follows: Salaries (Buying Expense), Salaries (Selling Expense), Salaries (Administrative Expense). This necessitates a recording of the entry in the Journal in such a manner that it may be posted to the proper account.

IV. By keeping controlling accounts in the General Ledger for each of the functional classifications and maintaining in a subsidiary Expense Ledger the detail accounts of each classification.

Under this method accounts would be kept in the General Ledger for Buying Expense, Selling Expense, and Administrative Expense. In the subsidiary Expense Ledger in separate sections all the individual accounts for each classification would be kept. The functional classification accounts in the General Ledger would be controlling accounts for each of the groups of individual accounts kept in the subsidiary Expense Ledger.

It is out of the scope of this text to discuss the merits of the various methods outlined above, which are only some of the many methods used in accumulating expense data.

In the work of this text, method number one will be used largely because of its simplicity.

Distribution of Expenses to Departments. In the previous chapter the departmentizing of a business was discussed and the method of obtaining the gross profit for each department was illustrated. In this illustration the total of the operating expenses was deducted from the total gross profit to obtain the combined net operating profit of all the departments.

It is important to learn not only the gross profit from each department, but also the cost for each department of earning this profit and the net operating profit of each department. It is possible that a department may show a very satisfactory gross profit, but when it is charged with its proper portion of the operating expenses it may show an operating loss.

There are many methods used in allocating the operating expenses to the various departments. The same methods explained under the functional expense classification may be used for departmental expenses. Inasmuch as emphasis is now being placed merely on the necessity of the allocation of the expenses to the departments and not on the methods of such allocation, no discussion will be given of the more scientific methods of expense distribution. A simple method of distribution, based upon the ratio of net departmental sales to the total net sales, will be used in the illustration given on the following pages. This method of expense distribution may be expressed by the following formula:

$$\frac{\text{Net Departmental Sales}}{\text{Net Total Sales}} \times \text{Expense} = \text{Portion of this expense chargeable to a Department}$$

Illustrative Departmentalized Profit and Loss Statement.
 The following Profit and Loss Statement illustrates a form of exhibiting the operating results of a business which has three departments and which prorates the expenses on the basis of net sales.

WILLIAM JONES

EXHIBIT B

Profit and Loss Statement, January 1-June 30, 19—

	Dept. A		Dept. B		Dept. C		Total
Gross Sales	80,000	—	100,000	—	20,000	—	200,000
Less: Sales Returns and Allowances	3,200	—	4,000	—	800	—	8,000
Net Sales	76,800	—	96,000	—	19,200	—	192,000
Deduct: Cost of Goods Sold (Schedule 1)	41,000	—	75,500	—	16,900	—	133,400
Gross Profit	35,800	—	20,500	—	2,300	—	58,600
Deduct: Operating Expenses:							
General Administrative Expense (Schedule 2)	3,840	—	4,800	—	960	—	9,600
Buying and Receiving Expense (Schedule 3)	2,304	—	2,880	—	576	—	5,760
Selling and Delivery Expense (Schedule 4)	7,800	—	9,750	—	1,950	—	19,500
Total Operating Expenses	13,944	—	17,430	—	3,486	—	34,860
Net Operating Profit	21,856	—	3,070	—	*— 1,186	—	23,740
Add: Other Income							
Discount on Purchases					3,200	—	
Recovery of Bad Debt					800	—	
Interest Income					1,800	—	5,800
Total Income							29,540
Deduct: Other Charges							
Discount on Sales					3,300	—	
Bad Debts					2,200	—	
Interest Expense					1,400	—	6,900
Net Profit for the Period							22,640
*Net Loss							

WILLIAM JONES

EXHIBIT B, SCHEDULE 1

Cost of Goods Sold for the Six Months Ending June 30, 19—

	Dept. A		Dept. B		Dept. C		Total	
Inventory, Jan. 1, 19—	12,000	—	25,000	—	3,000	—	40,000	—
Purchases, net	40,000	—	100,000	—	20,000	—	160,000	—
Freight In	1,000	—	2,500	—	500	—	4,000	—
Total Cost of Goods	53,000	—	127,500	—	23,500	—	204,000	—
Less: Inventory, June 30, 19—	12,000	—	52,000	—	6,600	—	70,600	—
Cost of Goods Sold	41,000	—	75,500	—	16,900	—	133,400	—

WILLIAM JONES

EXHIBIT B, SCHEDULE 2

Analysis of General Administrative Expenses for the Six Months Ending June 30, 19—

Account	Total	Apportioned on Basis of Net Sales		
		Dept. A 40%	Dept. B 50%	Dept. C 10%
Salaries	7,500 —	3,000 —	3,750 —	750 —
Rent	600 —	240 —	300 —	60 —
Stationery and Supplies	300 —	120 —	150 —	30 —
Telephone and Telegrams	240 —	96 —	120 —	24 —
Insurance	214 —	85 60	107 —	21 40
Depreciation on Equipment	200 —	80 —	100 —	20 —
Sundry General	240 —	96 —	120 —	24 —
Taxes	306 —	122 40	153 —	30 60
	9,600 —	3,840 —	4,800 —	960 —

360 EXPENSE CLASSIFICATION AND DISTRIBUTION

WILLIAM JONES

EXHIBIT B, SCHEDULE 3

Analysis of Buying and Receiving Expenses for the Six Months Ending
June 30, 19—

Account	Total	Apportioned on Basis of Net Sales		
		Dept. A 40%	Dept. B 50%	Dept. C 10%
Salaries	4,900 —	1,960 —	2,450 —	490 —
Rent	400 —	160 —	200 —	40 —
Stationery and Supplies	30 —	12 —	15 —	3 —
Telephone and Telegrams	175 —	70 —	87 50	17 50
Insurance on Equipment	12 —	4 80	6 —	1 20
Depreciation on Equipment	40 —	16 —	20 —	4 —
Sundry Buying and Receiving	203 —	81 20	101 50	20 30
	5,760 —	2,304 —	2,880 —	576 —

WILLIAM JONES

EXHIBIT B, SCHEDULE 4

Analysis of Selling and Delivery Expenses for the Six Months Ending
June 30, 19—

Account	Total	Apportioned on Basis of Net Sales		
		Dept. A 40%	Dept. B 50%	Dept. C 10%
Salaries	6,000 —	2,400 —	3,000 —	600 —
Commissions	2,500 —	1,000 —	1,250 —	250 —
Advertising	1,020 —	408 —	510 —	102 —
Insurance	1,100 —	440 —	550 —	110 —
Traveling Expense	1,500 —	600 —	750 —	150 —
Rent	2,400 —	960 —	1,200 —	240 —
Taxes, Apportioned	1,800 —	720 —	900 —	180 —
Telephone and Telegrams	800 —	320 —	400 —	80 —
Depreciation on Equipment	500 —	200 —	250 —	50 —
Delivery Expenses	700 —	280 —	350 —	70 —
Freight and Express Out	400 —	160 —	200 —	40 —
Sundry Selling and Delivery	780 —	312 —	390 —	78 —
	19,500 —	7,800 —	9,750 —	1,950 —

It should be noted in examining the illustrated Profit and Loss Statement that Department B shows a net operating profit of slightly more than three per cent and that Department C shows a net operating loss. Department A, on the other hand, on a volume of business which is less than that of Department B, shows a net operating profit of more than thirty per cent.

While the variations of operating results in this illustration are slightly exaggerated in order to bring out the point, yet they indicate a condition which exists in many businesses, namely, certain profitable departments carrying departments which are either not profitable at all or in which the profit is not commensurate with the cost of obtaining it. Such a condition may only be determined by departmentizing the business and charging a proper portion of the operating expenses to each department.

Summary. In the last two chapters further analysis of the nominal accounts has been made to indicate in a very small way the possibilities of the use of accounting data in the management of a business. An executive furnished with the facts which have been analyzed and coördinated is able to plan the future policy of the business with a confidence which is based upon an accurate picture of the past.

The illustrations given are merely indicative of the methods used in analyzing the results of operating and are not intended as complete or exhaustive treatises on the subject of departmentalization or expense distribution. On the other hand, these illustrations serve to indicate the importance of proper account classification in order to furnish the essential information regarding each activity of the business.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. Name the methods of classifying and distributing expenses.
2. Explain what is meant by the functional classification of expenses.
3. Why is method number one under Functional Expense the simplest to operate?
4. How would you distribute salaries to the functions of buying, selling and administration?
5. A business man asks the question, "What does it cost me to sell my goods?" In order to answer this question, what should be the procedure?
6. Why is it of importance to a business man to learn whether or not the various departments of his business are paying?
7. What are the advantages of a detailed Departmental Profit and Loss Statement?
8. Why are non-operating expenses not considered in departmental or functional distribution?
9. Explain the method of distribution of expenses to departments on the basis of net sales ratio.
10. Direct expenses of operating may be reclassified and distributed either by functional or departmental classification, or both. Explain.

CHAPTER XXIII

PARTNERSHIPS

Nature of Partnership Relationship. A partnership results when two or more persons contribute capital or services, either or both, to carry on a business for profit. Expressed more completely, a partnership results from a contract (expressed or implied) by two or more competent parties to invest certain property, services and skill, or some or all of them, to carry on a business for profit, in which the property and profits or the profits alone belong to the parties in certain ratios as co-owners.

An owner of an interest in the assets or profits of a partnership is called a partner. Sometimes he is referred to as a copartner. The partners taken collectively are called the firm.

A partner may be interested in the assets and profits or losses, or in the profits and losses alone, in any ratio agreed upon by the partners themselves. One partner may contribute all the capital or he may contribute none. He may contribute all his services or give little or none of his services to the business. Assets and services may be contributed in any agreed ratio. If a partner does not contribute some assets as capital, he must necessarily contribute certain services which entitle him to an interest in the profits.

In the absence of any agreement, partners are considered legally to be equal partners as to profits and losses. It is understood that unless an agreement is made to the contrary each partner shares losses in the same ratio as profits are shared. The interests of the partners in the assets of the partnership are reflected by the Capital accounts of the partners.

Articles of Copartnership. The written agreement drawn up by the partners is called the *articles of copartnership*. It is the contract entered into by the parties and should be carefully drawn up.

The articles of copartnership should state clearly the name of the firm, the names of the parties to the contract, the amount of their investments, their profit and loss ratio, the services to be rendered by each, the procedure at dissolution, and any special arrangements as to interest allowances on investment, salary, drawings, etc., upon which the partners may agree.

A partnership contract is implied when, though there is no written agreement, the parties conduct themselves in a manner which implies a partnership relationship. In such cases and where oral contracts are made, misunderstandings and disputes often arise which are not always easy to settle and may even require the services of accountants and lawyers before they are finally disposed of.

Characteristics of a Partnership. The following characteristics are present in every partnership, due to the legal contract and the type of organization.

1. *Individual Control by Partners.* Each partner has individual control over the affairs of the firm. He acts as the agent of the other partners in the operation of the business. One partner can make contracts to buy and sell goods and services and the other partners or the firm is bound by his acts, provided they are within the scope of the business in which they are engaged.
2. *Limited Life of Partnership.* The life of a partnership may be terminated by —
 - (a) An agreement expressed in the original articles of copartnership.
 - (b) An agreement between the parties at any time.

- (c) The death or insanity of a partner.
 - (d) The bankruptcy of any of the partners.
 - (e) A bill in equity.
3. *Partners' Liability for Debts of the Firm.* Each member of a partnership is jointly and individually liable for the debts of the firm. He practically guarantees the payment of all partnership debts to the full extent of his personal capital. From this it is evident that the errors or misdeeds of one partner may be costly to the other partners.
 4. *Co-ownership of Profits and Losses.* Each partner is an owner of a share of the profits and losses, as specified in the partnership contract. An employee may share in the profits, by agreement, to a certain percentage, as a salary or commission, but he is not a partner because he does not have a proprietary interest in the profits. He is merely paid for services on a contingent basis. A partner, however, is entitled to his share of the profits and becomes an owner of his share whether he renders services or not.
 5. *Co-ownership of Assets.* Assets are owned by the partner or partners who invest them in proportion to their Capital investment ownership. Thus, at the time of starting a business as a partnership A invests \$10,000 and B invests \$5,000. Each owns the amount of capital that he invested, irrespective of his interest in the profits and losses. The problem of ascertaining the ownership interest in the assets of a firm for any partner is explained in full detail later.

Legal Interpretations Affecting Partnership Entity. The partnership is not a legal entity and cannot be sued or sue as a firm. The law recognizes the contractual relation existing, but does not consider the firm a separate legal body distinct from the owners. Consequently, when suit is entered at law, it must be against one of the partners or against all of them as individuals.

Types of Partnerships. Partnerships may be classified in several ways:

1. According to operations into general and special partnerships.
2. According to nature of the business into trading and non-trading partnerships.
3. According to manner of association into ordinary partnerships, limited partnerships, associations, joint stock companies.

A *general partnership* is one in which the partners agree to join or associate in all transactions of a particular class, and carry on a business in this class. This type makes up the great bulk of trading partnerships.

A *special partnership* is one in which the parties associate with respect to a single venture or deal. They are "temporary" partnerships and are not recognized as regular business enterprises. They are, however, quite common. Joint ventures and underwriting syndicates are types of partnerships which have as their object a single undertaking, and are very frequent in modern business.

A *trading partnership* refers to a firm doing a merchandising business.

A *non-trading partnership* is one that is not in the merchandising business. It refers to firms doing a banking or security-selling business, brokers, professional men, such as lawyers and accountants, insurance companies, etc.

An *ordinary partnership* (sometimes called *regular*) is one which rests on the rules of common law and accepted practice.

A *limited partnership* is one which is authorized by law in certain States and countries, whereby certain partners, called "special" partners, may be limited as to liability to

the amount of their original contributions. At least one partner must be a general partner of unlimited liability. The general partner must be actively engaged in the operation and management of the business, but this rule does not apply to the special partners.

Partnership associations are allowed under the laws of some States, where all partners have limited liability and the shares of interest are usually represented by stock certificates. These certificates are not freely transferable, however, and a person acquiring one must first be elected to membership before he is entitled to full participation in the business. They closely resemble corporations and are sometimes called *quasi-corporations*.

Joint stock companies are partnerships the capital of which is divided into shares, which are freely transferable. They are formed under the statute law in most States. A joint stock company is not a legal entity and in this respect is like a partnership.

Partners Classified. Partners are classified on the basis of their participation in the activities of the firm under the articles of copartnership into *general, special, ostensible, secret, silent* or *dormant partners*.

A *general partner* is one who has a full voice in the management of the enterprise and unlimited liability for the debts of the firm.

A *special partner* is a member of a limited partnership who is limited in event of loss to the amount of capital he invests. Creditors must usually be advised which partners are special and to what extent they are liable.

An *ostensible partner* is one who appears by inference to be a partner, although he is not a partner by agreement. Creditors may hold him liable unless he specifically denies any connection with the firm.

A *secret partner* is one whose connection with the firm is not known or made public. He may have a considerable interest in the firm's assets and share profits and losses, and have a voice in the management.

A *silent partner* has no voice in the management of the enterprise but shares in the profits and losses.

A *dormant partner* is one in whom the characteristics of secret and silent partners are combined.

If the firm name contains all the names of the partners, each one is then considered a general partner. For example, A, B, and C may form a partnership under the name of A, B, & C. If the name used is A, B, & Company, then C might be a general, secret or dormant partner, as per agreement. If they should choose a name such as X Trading Company, this name must be registered at the City or Town Clerk's office and the names of the firm members given.

Advantages and Disadvantages of a Partnership. The advantages of partnerships are:

1. Combination of skill and services of a number of persons interested as owners.
2. Ease and quickness with which formed.
3. Absence of governmental regulation.
4. Absence of any restriction as to the sphere of its activities. A change from one type of business to another, or unlimited expansion, may be made at will.
5. Promptness with which it may act.

The disadvantages of partnerships are:

1. Unlimited liability of partners.
2. Possibility of dissolution being forced by events beyond the control of partners.

3. Difficulty of securing full coöperation of all partners in the management of the enterprise.
4. Difficulty of freely transferring the interest of a partner in the business.
5. Limitation on the expansion of the business because of the limited source of capital.

Accounting Problems Created by Partnerships. The same accounting problems which prevail in a single proprietorship business as to assets and liabilities, expense and income, are present in partnerships. The same cycle of operations and processes of accounting are present. The balance sheet and the profit and loss statement are identical as to form and content. The same books and records are used in the bookkeeping system.

New problems peculiar to partnerships center around the handling of the accounts used to reflect the capital interests of the partners. These problems require careful analysis in order that they may be solved with due regard for the rights and interests of all partners. They generally involve correct expression in the accounts of the vague and incomplete partnership agreements, valuation of the investments, sharing of profits and losses, adjustment of unequal capital contributions, and the final distribution of assets in liquidation, dissolution, or change in type of organization.

Capital Interest versus Profit and Loss Interest. A partner may have an interest in the assets of the partnership either through investment of capital or by allowing a portion of his profits to remain in the partnership. It is possible for a person having no interest in the assets of the partnership to be a partner, providing he participates as owner in the profits and losses of the business.

There is no necessary relationship between the capital interest and the profit and loss interest. One partner may

invest all or the greater portion of the assets and yet receive only a small percentage of the profits. Another partner may invest very little or no capital assets and still receive the largest share of the profits.

The capital interest of each partner is the balance of his Capital account after being credited with his proportion of the gains or charged with his proper share of the losses. The profit and loss interest is determined from the agreement of the partners or, in the absence of an agreement, according to partnership law.

In order to avoid possible disagreements, a complete statement should be made in the articles of copartnership of the interests of the partners in the assets and the profits and losses.

Interest in the Assets. The interest in the assets, as stated previously, is the result of actually contributing to the capital of the firm or allowing the profits to accumulate and not withdrawing them. It may, after a period of years, be a combination of both original contribution of assets and the addition to them of the profits accruing to the partner. The proportion of each partner's interest in the net assets is always shown by the balance on the Ledger in his Capital account or accounts at the end of a period.

For example, after closing the books the following is a balance sheet of A & B, a partnership in which the profits and losses are shared equally.

A & B

BALANCE SHEET, DECEMBER 31, 19—

Cash	\$20,000	Accounts Payable	\$12,000
Real Estate	30,000	Notes Payable	10,000
Accounts Receivable	50,000	Mortgage Payable	15,000
Merchandise Inventory	15,000	A, Capital	37,000
Goodwill	10,000	B, Capital	51,000
	<u>\$125,000</u>		<u>\$125,000</u>

If the business is liquidated or sold at the values shown in the above balance sheet, A should receive \$37,000 and B \$51,000 from the proceeds. The balance of capital shown in the balance sheet shows the ownership interest of each partner in the assets of the partnership. This is always true irrespective of any profit-and-loss-sharing ratio.

Interest in Profits and Losses. As stated previously, the interest of each partner in the profits and losses is according to the agreed ratio. In the absence of any agreement or direct evidence of an agreement, each partner's interest is equal. The interest in the profits and losses of the partners may be related to the capital ratio, but more often has no relation to the investments.

Partners may agree to share profits and losses in any way they desire. Some of the influences which affect the determination of the profit-sharing ratios are — capital contribution or ownership, services to be performed, abilities and skill of the partners.

Partners may agree to share profits and losses in any of the following ways:

1. According to original invested capital.
2. According to average capital invested.
3. According to services performed or value of services to be rendered.
4. According to certain trade relationships of the partners which attract business to the firm.
5. Equally or by an arbitrary percentage irrespective of any capital ratio or services rendered.
6. In case of unequal capital contribution, the profits and losses may be distributed equally or otherwise after first attempting to compensate for unequal capital ownership by the allowance of interest on the capital, and for unequal services by allowing a salary for the services rendered.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Define a partnership, copartner, firm.
2. State what the articles of copartnership should contain.
3. What are the characteristics of a partnership?
4. What do you understand by the statement that a partnership is not a legal entity?
5. Name the types of partnerships. Define each.
6. Name and define each of the different classes of partners.
7. State the advantages of a partnership.
8. State the disadvantages of a partnership.
9. Do you consider the partnership type of organization a good one for certain businesses? Why?
10. Are there any special problems in accounting introduced by the partnership?
11. Explain what is meant by capital interest of a partner.
12. How is a partner's interest in the profits and losses determined?
13. It is stated that the Capital account of a partner combines two separate and independent interests. Explain.
14. How does the Capital account on a trial balance differ from that in a balance sheet?
15. What does the Capital account balance of a partner on a balance sheet show?
16. The asset ownership and profit and loss ownership are merged each period. How does this affect the capital interest ratio?
17. Name several methods by which partnership profits and losses may be distributed.

CHAPTER XXIV

PARTNERSHIP ACCOUNTS

Need for Records of Partner's Interest. Due to the fact that several persons are interested in various ways in the assets and results of operation of a partnership, it is essential that the accounts kept should reflect in as accurate a manner as possible the interest of each partner in the assets and profits and losses of the partnership. Careful selection of the accounts should be made so that all the provisions of the articles of copartnership as well as any special agreements, oral or written, may be properly recorded.

The uncertainty as to the length of life of a partnership makes a scrupulous distinction between capital and revenue expenditures imperative. An error in this regard does not seriously affect a single proprietor in his own business because the entire business belongs to him and should he die it goes to his heirs. An error in recording a single transaction of a partnership may cause serious loss to one or more of the partners, particularly in the event of dissolution.

Partner's Investment Account. This account is intended to record the partner's permanent investment in the business. Sometimes it is the only account kept and is used to record investments, drawings, and salary. The functions of this account when it is the only account kept with each partner are shown on the following page. In this explanation of the Capital account of a partner all possible debits and credits are shown in one account. Each debit is lettered and each credit numbered for reference purposes in the account functions which follow.

 Partner's Capital (Separate account with each partner)

Debited for:

- A. Withdrawal of investment
- B. Withdrawal of profits
- C. Payments of salary
- D. Loans repaid
- E. Charge of interest on withdrawals or deficiency of capital
- F. (Net loss from operations)

Credited for:

- 1. Investment at time of formation of partnership
- 2. Additional investments
- 3. Allowances for salary
- 4. Loans made to the business
- 5. Allowance for interest on investment
- 6. Net profit from operations

The balance of this account is usually a credit and shows the partner's capital interest in the business.

When there are numerous transactions affecting the partner's account the use of one account is unsatisfactory and would require analysis into its elements for a correct interpretation. A better policy is to restrict the use of the Partner's Capital account to the recording of the permanent investment and to use one or more accounts to record withdrawals of profits, salary allowances, and interest on investments or withdrawals.

The functions of the Partner's Investment account when used with a Drawing account are as follows:

 Partner's Capital (Separate account with each partner)

Debited for:

- A. Withdrawals of capital
- D. Loans repaid

Credited for:

- 1. Original investment or balance at beginning of a period
- 2. Additional permanent investments
- 4. Loans to the business

The balance is usually a credit and shows the investment remaining in the business.

Partner's Drawings. The money or property drawn out from a partnership may be either a withdrawal of the original investment or a part of the profits earned or anticipated. A withdrawal of a part of the investment is made usually by mutual agreement between the partners, otherwise it

would in all probability be a breach of the articles of co-partnership. Such a withdrawal may be made because of an excess of capital in the business and as it constitutes a permanent reduction of the capital should be charged to the Partner's Investment account.

Usually a partner, in making a withdrawal, does not intend to decrease his permanent investment, but considers the amount withdrawn to be taken from profits already made and credited in his Drawing account or from profits which the business is expected to earn.

Partner's Drawing Account. The Partner's Drawing account (also called Personal or Current account) may be used to record both the withdrawals of profits and transactions involving salary and interest on capital. When so used the functions of this account are:

Partner's Drawing (Separate account with each partner)	
Debited for:	Credited for:
B. Drawings made against profits	3. Salary allowance (if any)
C. Drawings made as salary	5. Any interest adjustments credited
E. Interest charged (if any)	6. Net profit.(at end of period)
F. (Net loss, if any)	

Balance, if a credit, represents additional capital in the business; if a debit, shows excess of drawings over profits and represents a decrease in investment.

This account may be closed into the Capital account at the end of the period or allowed to remain open and carried along as an open account from period to period. On the balance sheet, however, the Capital and Drawing accounts should be merged into one amount to show the actual capital ownership of each partner.

Partners' Salaries. Partners are not entitled to draw salaries from a partnership unless there is a specific agreement between the partners to do so. This agreement should be incorporated in the articles of copartnership but may be

made at any time by an agreement between the partners. In the absence of any such agreement no partner can claim compensation for services even though, through sickness or other disability of another partner, he is forced to do more than his ordinary share.

From an accounting viewpoint everything a partner receives from the partnership (except drawings of investment), whether it is received as salary, or interest on investment, or profits, is considered as profits. If salaries are allowed the partners, such payments are to compensate the partners according to their respective abilities and in reality are nothing more than a primary distribution of profits.

Differences in ability and time given to the business may be adjusted through salary allowances and the balance of the profits distributed in the agreed ratio.

For example: A and B own a business. A has a capital of \$10,000 and B \$5,000. The agreement is that A will receive one half of the profits and B one half, but it is also agreed that A will draw a salary of \$2,000 yearly and B \$3,000 yearly before sharing equally the remaining profits and losses. The net profits of A and B were \$10,000 before any distribution was made.

Solution:

Net Profits			\$10,000
Distributed as follows:			
A, Drawing Account — Salary	\$2,000		
B, Drawing Account — Salary	<u>3,000</u>	\$5,000	
A, $\frac{1}{2}$ Remaining Profits		2,500	
B, $\frac{1}{2}$ Remaining Profits		<u>2,500</u>	<u>10,000</u>
A receives Salary, \$2,000; Profits, \$2,500; Total,	\$4,500		
B " " 3,000; " 2,500; " 5,500			
			<u>\$10,000</u>

The salary and profits would be distributed by the following closing entry:

Profit and Loss	10,000	
A, Drawing Account (for salary)		2,000
A, Drawing Account (share of net profits)		2,500
B, Drawing Account (for salary)		3,000
B, Drawing Account (share of net profits)		2,500
To distribute net profits.		

The Drawing accounts of A and B would then appear as follows:

A, Drawing		B, Drawing	
Debit:	Credit:	Debit:	Credit:
C. Drawings as made	4. Salary 2,000 6. Profit 2,500	C. Drawings as made	4. Salary 3,000 6. Profit 2,500

By this method no account is kept with Salary, as such, it being considered a part of the Drawing account. Each amount as drawn by the partner is charged to his Drawing account. At the end of the period the debit of the Drawing account would show the salary drawn and may be compared with the amount shown as a credit for salary allowed.

In this type of agreement it is expected that the salary drawings will be all the drawings made. If the drawings made by any partner are greater than the salary allowance, the debit of the Drawing account may be analyzed to determine that proportion of drawings which is salary and that proportion which is drawn against profits in excess of salary.

Partner's Salary Account. A separate account called Partner's Salary account is sometimes used in practice. If this account is kept, it is a secondary Drawing account and becomes a detailed account which measures solely the salary

allowed and drawn. The functions of this account are as follows:

Partner's Salary (Separate account with each partner)

Debit:	Credit:
C. During a period with amounts of salary drawn	4. At end of a period with amount of salary allowed

This account should balance provided the salary drawn was equal to the amount allowed. If the drawings were less, a credit balance results which shows salary not taken; if drawings were more, a debit balance results which shows overdrawn salary.

In a balance sheet the balance of this account, if any, may be merged with the Partner's Capital accounts or carried as a separate item.

* When a Partner's Salary account is used in addition to the Drawing account, the functions of the Drawing account are as follows:

Partner's Drawing (Separate account with each partner)

Debited for:	Credited for:
B. Withdrawals from profits	5. Allowances for interest on investment
E. Interest charged on above drawings or on deficiency of capital	6. Net profit for the period
F. (Net loss for the period)	

The balance of this account, if a credit, represents the excess of net profits and other credits over the charges made against profits and it amounts to an increase in the partner's capital in the business. If the balance is a debit, it represents the excess of the charges over the credits and results in a reduction of the partner's capital.

Salaries of Partners — Classification. In making a Profit and Loss Statement there is frequently considerable

discussion as to whether salaries of partners should be considered an operating expense or a distribution of profits. If salaries of partners is treated as an expense, the net profit shown will be the profits earned less the salaries.

If the salaries of partners is treated as a distribution of the net profit, the net profit shown by the Profit and Loss Statement will be the net profit earned by the business before salaries are deducted. This net profit would then be analyzed into salaries allowed, and the net profit after salaries.

The showing of the salaries as a distribution of net profits is preferred by the authors as all the information is clearly shown by this method. Salaries of partners are not considered in this method as an expense of the business, but as a sharing of profits by the partners. (See Form, page 395.)

Partners' Salaries as an Element of Economic Net Profit.

The economic idea of net profit is what is left of the income after all expenses have been deducted, including salaries of the managers and interest on the capital used in the business.

Frequently the partners desire information as to what the business can earn after paying them a reasonable amount for their services. If this is the purpose of the allowance for salary, an entry may be made periodically charging an expense account, Salaries of Partners, for the amounts agreed upon as salary and crediting the individual partner's Drawing or Salary account. This account would then be treated as any other expense account and closed into profit and loss for the period.

The amounts paid to the partners as salary under this method must, in the final analysis, be considered as a part

of the partnership profits. It is, therefore, nothing more than a distribution of profits through a charge to a fictitious expense account.

Interest Allowances on Investments. Differences in capital ratio of investments by the partners may be adjusted by an allowance to each partner of interest on his capital. The interest thus allowed is to be considered, like salaries, as a primary distribution of profits. In the allowance of such interest, consideration should be given to changes in capital. Interest may be allowed on original capital contributed, but if the Investment accounts are changing frequently, it is better to allow interest on average capital investment.

Frequently, when interest is allowed on investments, the partners are charged interest on drawings in excess of salary allowance. In such cases the excess of the interest allowed on capital over the interest charged on drawings, represents the amount of profits distributed under the guise of interest. This is in reality a distribution of profits according to capital ratio.

No entries are required to record either the interest allowed on capital or charged on drawings, but this adjustment may be included as part of the net profit distribution.

To illustrate: Assume that A and B are partners; that A invested \$10,000 and B \$2,000; that they agreed that A should receive a salary of \$3,000 and B a salary of \$4,000; that they allow interest on the partners' investments and charge interest on any withdrawals in excess of salary at the rate of 6 per cent; that A withdrew \$500 for six months; and that they share remaining profits equally. Net profits before salary or interest were \$10,000.

Solution:

Net Profits for the period			\$10,000.00
Distributed as follows:			
A, Salary	\$3,000.00		
B, Salary	4,000.00	\$7,000.00	
A, Net Interest * .	585.00		
B, Net Interest *	120.00	705.00	7,705.00
Balance after Salary and Interest			2,295.00
A, $\frac{1}{2}$ Remaining Profits		1,147.50	
B, $\frac{1}{2}$ Remaining Profits		1,147.50	2,295.00
* Interest allowance calculations:			
A invested \$10,000.00 for 1 year @ 6%		\$600.00	
A withdrew \$500.00 for 6 months @ 6%		15.00	
A, Net Interest			\$585.00
B invested \$2,000.00 for 1 year @ 6%			120.00
			<u>\$705.00</u>

The following entry would be made to close the Profit and Loss account into the Partners' Drawing and Salary accounts:

Profit and Loss	10,000.00	
A, Salary Account		3,000.00
B, Salary Account		4,000.00
A, Drawing Account (for interest)		585.00
A, Drawing Account (net profits)		1,147.50
B, Drawing Account (for interest)		120.00
B, Drawing Account (net profits)		1,147.50

To close the Profit and Loss account into Partners' Drawing and Salary accounts.

Interest Allowance in Economic Net Profit. If the interest on capital is considered with the purpose of arriving at the so-called economic net profit, an entry may be made debiting the expense account, Interest on Capital, and crediting the Partner's Drawing account. The entry to

record the interest allowance of the illustration used above is as follows:

Interest on Capital	705.00	
A, Drawing		585.00
B, Drawing		120.00

To provide for allowance of interest on investment calculated as follows:

A invested \$10,000 —		
1 yr. — 6%	\$600	
A withdrew \$500 —		
6 mos. — 6%	15	\$585
B invested \$2,000 —		
1 yr. — 6%	\$120	

The salary allowances should also be considered as expenses and the following entry made:

Salaries of Partners	7,000.00	
A, Salary or Drawing Account		3,000.00
B, Salary or Drawing Account		4,000.00

To record the salary allowances.

Having considered the interest and salary of partners as expenses, the net profit remaining and shown by the Profit and Loss Statement would be \$2,295.00. This amount is distributed by the following entry:

Profit and Loss	2,295.00	
A, Drawing		1,147.50
B, Drawing		1,147.50

To close net profits to Partners' Drawing accounts.

Partner's Loan Account. Occasionally a partner advances to the firm funds which are intended to be temporary

loans, and not additional investments. Amounts so advanced should be credited to a special Loan account opened in the name of the partner making the advance and kept separate from the capital.

Loans made by a partner to the firm are entitled to interest even though there is no specific agreement to pay interest. In event of dissolution these loans are also entitled to priority over the capital. Such loans, however, are not ranked with outside creditors, but are payable only after all the claims of the outside creditors are settled in full.

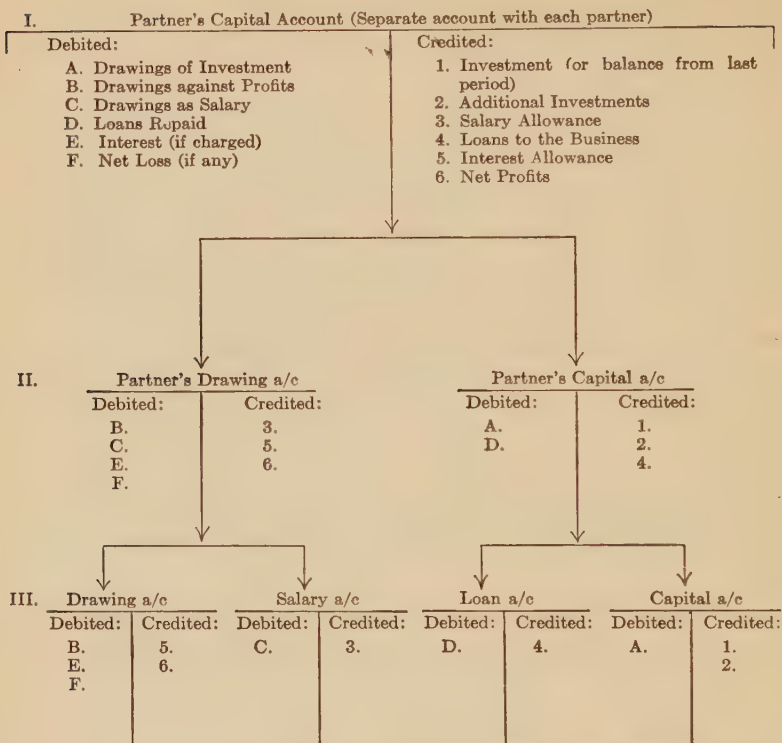
The interest paid on loans is considered as a financial expense and is not treated as a primary distribution of the profits of the partnership. If the money were borrowed from a bank or other outside creditor, this interest would definitely be an expense; therefore, in case a partner provides the loan funds, the interest on such loan is unquestionably an expense.

The functions of the Loan account would be as follows:

Partner's Loan (Separate account with each partner)	
Debit:	Credit:
D. With amount of loan repaid	4. With amount of loan when made

Balance, if any, shows unpaid loan and represents the liability of the partnership to the partner, and should be shown on the balance sheet under the Capital section. (See Form, page 393.)

CHART SHOWING ACCOUNTS WITH PARTNERS



I. All possible entries in one account. (Seldom used.)

II. Two accounts. (This is very frequently the plan used.)

III. Four accounts. (When desired or necessary this plan should be used. Each partner may have two, three, or four accounts. If there are a number of partners, several accounts are necessary to reflect the capital interests.)

Sharing the Results of Operating a Partnership. In many partnerships the results of operation are shared in proportion to the Capital accounts. This method of distribution seems to be based on the hypothesis that capital is the sole cause of the profits.

It is true that lack of capital many times is the cause of failure but it is also true that many businesses having an abundance of capital are failures. To-day, more than ever before, it is recognized that managerial ability is a more important factor in the success of a business than the capital. Given managerial ability, capital may be borrowed under proper security in almost any amounts at the prevailing rates of interest.

The sharing of the results of operating a partnership in proportion to the investments is not a sound basis as it ignores the so-called personal equation, which is in most cases the real cause for success.

The following is the most equitable and reasonable method of sharing the results of the operation of a partnership:

1. Adjust differences in ability by salary allowances.
2. Adjust differences in capital by interest allowance.
3. Share the balance of the net profit equally.

In other words, after paying the partners' salaries commensurate with their abilities and paying them for the money invested at the prevailing rates, the balance of the earnings is considered the result of the combination of the efforts of the partners and may be shared equally.

Problems in Profit and Loss Distribution. There is no rule for the distribution of profits and losses in partnerships. The control of capital and the value of the services and

abilities of the individual partners are the principal elements which influence the agreement entered into by the partners.

Where the profits and losses are distributed in a definite ratio no particular problem is presented. When certain elements of the partnership make it desirable to provide for unequal capital by the allowance of interest on capital, and for unequal services by salary allowances, there are complications which arise in distributing the profit or loss.

The following problems present some of these complications:

Profit Sharing According to Average Capital. Where the Capital accounts remain fairly constant and profits and losses are shared according to capital ratio, the problem of distributing profits is simple.

Thus, if A has a capital of \$10,000 and B a capital of \$5,000 and profits and losses are shared according to capital, A would receive ten fifteenths or two thirds of the profits and B would receive five fifteenths or one third of the profits.

Some mathematical problems may arise, however, provided the capital contributed is continually changing. The agreement may be that capital ratios at the beginning of the period will govern, or that the average capital determines the ratio.

The following problem illustrates a method of determining the average capital. A and B agree to share profits and losses according to average capital investment. Net profits for the year are \$12,400.

On the following pages is shown a solution of this type of problem. It is largely a mathematical problem in ratio and proportion.

The Capital accounts of A and B are as follows:

A, Capital Account				B, Capital Account			
19—		19—		19—		19—	
Mar. 1	2,000	Jan. 1	10,000	Feb. 1	3,000	Jan. 1	15,000
Sept. 1	1,000	July 15	5,000	June 1	1,500	Apr. 1	1,000
Oct. 1	1,000	Nov. 1	3,000			Oct. 1	1,500

A, Capital

		Month Dollars	
10,000	for 2 months	=	20,000 for 1 month
8,000	" 4½ "		36,000 " 1 "
13,000	" 1½ "		19,500 " 1 "
12,000	" 1 "		12,000 " 1 "
11,000	" 1 "		11,000 " 1 "
14,000	" 2 "		28,000 " 1 "
	<u>12</u>		<u>126,500</u>
			12 = 10,541.67

B, Capital

15,000	for 1 months	=	15,000 for 1 month
12,000	" 2 "		24,000 " 1 "
13,000	" 2 "		26,000 " 1 "
11,500	" 4 "		46,000 " 1 "
13,000	" 3 "		39,000 " 1 "
	<u>12</u>		<u>150,000</u>
			12 = 12,500.00
			<u>23,041.67</u>

\$23,041.67 = Total average capital

The net profit of \$12,400 will be shared as follows:

$$A = \frac{10,541.67}{23,041.67} \times 12,400 = \$5,673 = \text{A's share}$$

$$B = \frac{12,500.00}{23,041.67} \times 12,400 = \$6,727 = \text{B's share}$$

The average capital of A and B may be reduced to a percentage basis and the profits shared accordingly.

$$A = \frac{10,541.67}{23,041.67} = 45.75\% \times 12,400 = \$5,673 = \text{A's share}$$

$$B = \frac{12,500.00}{23,041.67} = 54.25\% \times 12,400 = \$6,727 = \text{B's share}$$

In the above problem the capital balance in the business is reduced to a month dollar basis by multiplying the balance of capital by the number of months it remains unchanged. The total month dollars is divided by twelve to reduce the capital to an average for the year. This average is then used as a basis of profit distribution.

The closing entry in the Journal to make this distribution when closing the books will be as follows:

	Date	
Profit and Loss		12,400.00
A, Drawing Account		5,673.00
B, Drawing Account		6,727.00
To close the Profit and Loss account.		

Distribution of Net Loss. When a net loss occurs and interest is allowed the following example illustrates the procedure.

Illustration: A and B have Capital accounts of \$10,000 and \$5,000 respectively, sharing profits and losses equally after allowing 6 per cent interest on capital. Suppose the net loss for the year is \$1,500.

It is necessary in this problem to treat the interest allowance as an addition to the net loss before distribution to the partners.

Solution:

Net loss for the year		\$1,500
Distribution —		
Add: Interest allowed on capital		
A, \$10,000 at 6%	\$600	
B, 5,000 at 6%	300	900
Total loss to distribute		<u>\$2,400</u>
A, 50%	\$1,200	
B, 50%	<u>1,200</u>	<u>2,400</u>

Proof:

A is charged for net loss	\$1,200	
A is allowed for interest	<u>600</u>	
Net loss distributed to A		\$600
 B is charged for net loss	 \$1,200	
B is allowed for interest	<u>300</u>	
Net loss distributed to B		<u>900</u>
Total net loss		<u><u>\$1,500</u></u>

When there is an allowance for interest and salary, and a net loss occurs, the solution is as follows:

Illustration: A and B are partners with capital investments of \$15,000 and \$5,000 respectively. Profits and losses are shared equally after salary allowance to A, \$2,000; B, \$4,000; and interest allowance on capital for one year at 6 per cent. A net loss of \$3,500 occurs for the year.

It is necessary in this problem to add salary allowance and interest allowance to the net loss before distribution to the partners.

Solution:

Net loss for the year		\$3,500
Add:		
Salary allowance		
A, Salary	\$2,000	
B, Salary	<u>4,000</u>	6,000
Interest on capital		
A, 6% on \$15,000	\$900	
B, 6% " 5,000	<u>300</u>	<u>1,200</u>
Total loss		\$10,700
Distributed as follows:		
A, 50%	\$5,350	
B, 50%	<u>5,350</u>	<u>10,700</u>

Proof:

A is charged with net loss		\$5,350
Less:		
Credit for salary	\$2,000	
Credit for interest	<u>900</u>	<u>2,900</u>
A's net decrease in capital		\$2,450
 B is charged with net loss		 \$5,350
Less:		
Credit for salary	\$4,000	
Credit for interest	<u>300</u>	<u>4,300</u>
B's net decrease in capital		<u>1,050</u>
Total decrease in capital		<u>\$3,500</u>

The above proof indicates that the net decrease in capital is not affected by the salary and interest on capital adjustments. While the profit and loss distribution is equal, the salary and interest allowances cause A to sustain a larger share of the net loss

Entries to close the Profit and Loss account would be made as follows:

	Date	
Profit and Loss		6,000
A, Drawing Account		2,000
B, Drawing Account		4,000
To set up salary allowances.		

	Date	
Profit and Loss		1,200
A, Drawing Account		900
B, Drawing Account		300
To credit the partners for interest on capital at 6%.		

	Date	
A, Drawing Account		5,350
B, Drawing Account		5,350
Profit and Loss		10,700
To close the Profit and Loss ac- count.		

After posting the above entries, the Capital accounts appear as follows:

Profit and Loss			
Dec. 31 Net loss for		Dec. 31 A. Drawing	5,350
the year	3,500 —	B. Drawing	5,350
31 Salaries	6,000 —		
31 Interest	1,200 —		
	<u>10,700</u>		<u>10,700</u>

A. Drawing a/c		B. Drawing a/c	
$\frac{1}{2}$ Loss	5,350 —	$\frac{1}{2}$ Loss	5,350 —
Salary	2,000	Salary	4,000 —
Interest	900	Interest	300 —

FORM OF PARTNERSHIP BALANCE SHEET

ALMY & BROWN

BALANCE SHEET, DECEMBER 31, 19—

ASSETS

Current Assets:

Cash in Bank		\$6,382.60	
Petty Cash		125.00	
Notes Receivable		2,500.00	
Accounts Receivable	\$25,692.60		
Less: Reserve for Bad Debts	1,850.00	23,842.60	
Merchandise Inventory		<u>21,200.00</u>	\$54,050.20

Securities Owned:

Stocks and Bonds Owned			8,000.00
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Fixed Assets:

Land		5,000.00	
Building	15,000.00		
Furniture and Fixtures	<u>1,645.00</u>		
	16,645.00		
Less: Depreciation Reserve	<u>4,200.00</u>	<u>12,445.00</u>	17,445.00
Goodwill			<u>4,275.80</u>

Deferred Charges:

Insurance Prepaid		156.75	
Taxes Prepaid		64.82	
Office Supplies on Hand		<u>87.50</u>	309.07

Total Assets\$84,080.07

LIABILITIES AND CAPITAL

Current Liabilities:

Notes Payable	\$8,000.00	
Accounts Payable	12,472.69	
Accrued Interest Payable	180.00	
Accrued Salaries and Wages	575.00	\$21,227.69

Fixed Liabilities:

Mortgage Payable	7,000.00
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<i>Total Liabilities</i>	<u>28,227.69</u>
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Capital:

W. J. Almy, Loan	5,000.00
W. J. Almy, Capital Balance	33,976.19
J. D. Brown, Capital Balance	16,876.19

<i>Total Liabilities and Capital</i>	<u>\$84,080.07</u>
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STATEMENTS OF CHANGES IN CAPITAL INTEREST

W. J. ALMY, CAPITAL

Balance at beginning		\$35,000.00
Add: Salary allowance	\$4,500.00	
Interest allowance	2,100.00	
One half remaining profits	2,276.19	8,876.19
Total credits		43,876.19
Less: Drawings		9,900.00
<i>Balance at end of period</i>		<u>\$33,976.19</u>

J. D. BROWN, CAPITAL

Balance at beginning		\$15,000.00
Add: Salary allowance	\$5,000.00	
Interest	900.00	
One half remaining profits	2,276.19	8,176.19
Total credits		23,176.19
Less: Drawings		6,300.00
<i>Balance at end of period</i>		<u>\$16,876.19</u>

FORM OF PARTNERSHIP OPERATING STATEMENT

ALMY & BROWN

PROFIT AND LOSS STATEMENT, JANUARY 1 — DECEMBER 31, 19—

Net Sales		\$137,875.00
Deduct — Cost of Goods Sold:		
Inventory, 1/1/19—	\$16,748.00	
Add —		
Purchases (Net)	105,872.50	
Freight In	2,487.25	
Total Cost of Merchandise	125,107.75	
Less —		
Inventory, 12/31/—	21,200.00	103,907.75
Gross Profit from Trading		33,967.25
Less — Operating Expenses:		
Salaries and Wages	11,487.60	
Rent, Heat and Light	2,475.00	
Telephone and Telegraph	387.62	
Advertising	1,200.00	
Insurance	245.60	
Taxes	175.40	
Depreciation on Equipment	150.00	
Office Stationery and Postage	162.50	
Miscellaneous Expense	274.67	16,558.39
Net Operating Profit		17,408.86
Add — Other Income:		
Interest Income	267.82	
Dividends Received	300.00	
Discount on Purchases	1,742.96	
Rent Income	1,200.00	3,510.78
Total Income		20,919.64
Less — Other Expense:		
Interest Expense	710.62	
Discount on Sales	2,467.26	
Bad Debts Provision	689.38	3,867.26
Net Profit, January 1 — December 31		<u>\$17,052.38</u>

FORM OF DISTRIBUTION OF NET PROFIT IN A PARTNERSHIP

ALMY & BROWN

DISTRIBUTION OF NET PROFIT

Net Profit from Profit and Loss Statement		\$17,052.38
Distributed as follows:		
Salaries of Partners		
W. J. Almy	\$4,500.00	
J. D. Brown	5,000.00	9,500.00
Balance after Salaries		\$7,552.38
Interest Allowance on Capital		
W. J. Almy, 6% on \$35,000	\$2,100.00	
J. D. Brown, 6% on \$15,000	900.00	3,000.00
Balance after Salaries and Interest		\$4,552.38
W. J. Almy, 50%	\$2,276.19	
J. D. Brown, 50%	2,276.19	\$4,552.38

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. What information should the partners' accounts reveal?
2. State the various items which may be debited and credited to the Capital account of a partner.
3. When would one account with a partner be sufficient as a Capital account?
4. Explain the purpose of a Drawing account of a partner.
5. Where a Capital and Drawing account are used simultaneously, explain how each is handled.
6. When may the Drawing account be closed into the Partner's Capital account and when is it desirable not to do so?
7. Why are drawings usually made against profits?
8. Explain the Partner's Loan account.
9. How is interest on a partner's loan handled?
10. Is a partner entitled to salary? Why?

11. Explain how the salary allowance may be handled in the accounts of a partnership.
12. When may a Salary account of a partner be kept separate from the Drawing account?
13. Distinguish between the terms Salaries of Partners and Partner's Salary account.
14. Explain how salaries of partners and interest allowances are handled in the so-called economic net profit analysis.
15. Interest allowances on investments of partners is a means of distributing certain net profits in the capital ratio. Explain.
16. Explain a plan for distribution of net profits of a partnership which is equitable and reasonable.
17. In determining the economic net profit or loss, salaries of partners and interest on capital are treated as an expense. Compare this method with that of showing the salaries and interest as a distribution of the net profit or loss.
18. Which method do you prefer, looking at it from an accounting viewpoint? From a partner's viewpoint?
19. Is there any advantage in allowing interest on capital when the remaining profits are divided in the capital ratio?
20. Name all the accounts which may be kept with a partner and, assuming all are kept at one time, state the functions of each account and how it is shown on a balance sheet.
21. When the Profit and Loss account shows a debit balance (a net loss) and the partners have a salary allowance and an interest on capital agreement, explain the procedure of closing the Profit and Loss account.
22. Explain how the average capital ratio may be found when the Capital account is changing frequently.

CHAPTER XXV

ADMISSION OF A PARTNER

IN most partnership problems the statement is usually made that a partner is admitted into a partnership. This statement is not literally true and its significance to the accountant should be noted.

A new partner is not actually admitted into a business. He and the old partners enter into an agreement which is to form a new partnership to take over or buy the old business which is now being operated by the old partners. They agree on certain capital investment ratios and also agree on the profit and loss ratios. These ratios will vary according to the agreement.

What in reality happens is that the old business is liquidated (potentially); each party has his own capital returned to him and then puts it into the new partnership according to the agreement.

Thus, if A and B have Capital accounts of \$10,000 and \$5,000 respectively and form a new partnership with C, each party to invest equal amounts in the new business, A and B would supposedly draw out their capital. Then A, B, and C would each invest \$7,500 in the new business. This, however, may be accomplished by having B buy from A \$2,500 of his capital and making the proper adjustment on the books.

Problems in Admission of New Partner. There are two ways a new partner may obtain an interest in the partnership:

1. By buying an interest from the old partners;
2. By investing an agreed amount to obtain an interest in the new partnership.

When a new partner buys an interest from the old partners, the capital of the partnership is not increased and the old partners are reimbursed out of the amount paid by the new partner for the capital interest they surrender or sell.

When a new partner invests an amount which is to give him a certain ratio in the new firm, the capital of the partnership is increased and whatever money the new partner invests stays in the new business and creates additional capital.

There should be a very definite understanding as to the distinction between buying an interest and investing to secure an interest in a partnership. The first transaction is one of a personal nature between the old partners and the new partner, who is a purchaser of property from them. In the second proposition the new partner is an investor and puts money or assets into the new business with the result that the new partnership has a larger capital than the old. His investment becomes partnership property, owned by all the partners. In the first case, the property which the new partner contributes does not become partnership property but is owned and divided by the old partners among themselves.

Terminology — Interest in the Business. The term *interest in the business* is one which may or may not carry a double meaning.

A partner has two interests in a business, one is his interest in the assets or capital and the other is his interest in the profits and losses. Even the interpretations of the courts are somewhat confusing as to these terms. The term *interest in the business* should mean first an interest in the assets, which carries with it an interest in the profits. In case a partner has no capital investment, having only an

interest in the profits, he is "interested in the business" only as to profits and losses.

The phrase *half interest in a business* should imply a contribution of one half of the total capital as well as the right to receive one half the profits.

In solving partnership problems the interests of the partners in assets and profits and losses should be definitely stated. If not so stated, the statements made should be interpreted in as logical a manner as possible. Where confusion appears in the statements a supposition of the agreements should be made and the problem solved accordingly.

Goodwill. Goodwill is an intangible asset which should appear on the books of any business only when it is purchased or sold. It is brought about by the willingness of the purchaser of a business to pay the seller a value in excess of the actual or book value of the net assets as shown by a balance sheet at the date of the sale contract.

If assets to the book value of \$10,000 are bought for \$15,000, then the excess of \$5,000 over the book value is considered goodwill and is so recorded on the books of the purchaser.

Goodwill arises from inherent qualities in the previous business, or assets purchased, to produce income. Because of this fact, goodwill is sometimes described as the value of the earning power of a business. To state it differently, goodwill arises because of earning possibilities in the assets purchased. This earning power may be influenced by favorable location, reputation, trade name or other circumstances, but it is a fact that a purchaser of a business is willing to pay more for the net assets than the book value only because he thinks there is a possibility of making a satisfactory future income from the transaction.

When goodwill is purchased for cash there usually is little question of its value. When a corporation purchases goodwill and pays for it by issuing stock certificates, which are evidences of ownership only, the value of the goodwill may be very much inflated.

Goodwill becomes an asset to the purchaser and is so recorded on his books. The seller realized an income from the sale of the goodwill, for the reason that the sale resulted in an increase of assets which becomes an increase of capital or income.

If the seller has a goodwill asset recorded on his books at a certain value, he makes a profit only provided he realizes more for the goodwill than is recorded on his books. If he sells for exactly book value no profit is realized. If he sells for less than book value of course he suffers a loss on his goodwill.

Goodwill in Admission of a Partner. When a partner is admitted into a partnership there is an entirely new business formed to which the old business sells its capital ownership.

For example: A is in business and has a capital net worth of \$10,000 according to his balance sheet. A and B agree to form a partnership, agreeing to invest equal capital and share profits accordingly. A is to invest his present business and B is to invest cash of equal value. B agrees to invest \$12,000 cash for a one-half interest in the assets and profits and losses.

The fact that B and A have agreed that \$12,000 is to be one half of the capital in the new business places a capital value of \$12,000 on the other half, which is A's business. A, therefore, sells to the new partnership his business and receives in exchange capital ownership rights in the partner-

ship of \$12,000. As his book assets are valued at \$10,000 there is a goodwill asset of \$2,000, which must be added to the assets of A to make his capital \$12,000.

The following balance sheet is the result.

A & B			
BALANCE SHEET (Date)			
ASSETS		LIABILITIES AND CAPITAL	
Net Assets (A)	10,000	Capital	
Goodwill (A)	2,000	A, Capital	12,000
Cash (B)	12,000	B, Capital	12,000
	<u>24,000</u>		<u>24,000</u>

Adjusting Partners' Accounts. In starting any new business, a new set of books may be opened or the books used in the old business may be continued and proper adjusting entries made to bring the Capital accounts into the agreed ratio.

Where new books are started in a partnership the opening entries for the investment of each partner would be to debit the assets invested and to credit the liabilities and capital interest of each partner for the proper amounts. A separate entry may be made for each partner's investment.

More frequently the old books would be continued and the entries made —

1. To adjust the accounts of the old business to reflect the terms of the articles of copartnership as to the investment ratio of the old partners.
2. To bring on to the books the investment of the new partner or partners.

In the illustration used previously, page 400, the following entries would properly adjust the books of A and start the partnership accounts. A's books would then be continued and used for the partnership.

	(1)	
Goodwill	2,000	
A, Capital		2,000
To adjust A's Capital account according to agreement.		—

	(2)	
Cash	12,000	
B, Capital		12,000
To record B's investment as per agreement.		

Goodwill Distribution to Two or More Partners. Where there are two or more partners in a business and a new partner is to be admitted, whatever goodwill arises out of the agreement to form the new partnership belongs entirely to the old partners.

Illustration: The partnership of A and B, in which each partner has a capital of \$12,000, desires to form a new partnership with C. C is to have a one-third interest in the assets and profits and losses on condition that he invests \$15,000 as additional capital.

The fact that \$15,000 is the value of a one-third interest places a value of \$30,000 on the two-thirds interest of A and B. According to the books of A and B their total capital is \$24,000. They are going to invest this amount and receive a \$30,000 capital interest in return. This increase from \$24,000 to \$30,000 is goodwill and will be shared by A and B in their profit-sharing ratio.

The following entries would adjust the accounts on the

books used by A and B, the new partnership using the same records:

(1)		
Goodwill	6,000	
A, Capital		3,000
B, Capital		3,000
To record the goodwill.		

(2)		
Cash (or other Assets)	15,000	
C, Capital		15,000
To record the investment of C in the partnership of A, B, and C.		

Goodwill Not Recorded as an Asset. Sometimes it is desired not to reflect goodwill as an asset on the books. In such a case the adjustment of Capital accounts would depend on the partnership agreement.

A and B in the previous problem have Capital accounts of \$12,000 each, and C is to be admitted as a partner with a one-third interest in the assets and profits on condition that he invest \$15,000. No goodwill is to be recorded on the books.

Since C is to have a one-third interest in the assets, then A, B, and C will each have the same balance in their Capital accounts.

BALANCE SHEET OF A, B, AND C

ASSETS		LIABILITIES AND CAPITAL	
A and B	24,000	A, Capital	13,000
C	15,000	B, Capital	13,000
		C, Capital	13,000
	<u>39,000</u>		<u>39,000</u>

The above balance sheet shows the resulting condition after admitting C. It will be necessary to adjust all Capital accounts to be equal.

The following entries may be made:

(1)

Cash (or other Assets)	15,000	
C, Capital Account		15,000
To record C's investment.		

(2)

C, Capital Account	2,000	
A, Capital Account		1,000
B, Capital Account		1,000
To make all Capital accounts equal.		

This last adjustment is to equalize the Capital accounts of A, B, and C, and represents the payment to A and B of \$2,000 by C for his interest in the goodwill of the firm.

Should the agreement made by A and B with C be that C should invest \$15,000 — receiving credit therefor — and should also be entitled to a one-third interest in the profits and losses, the result would be reflected as follows:

BALANCE SHEET OF A, B, AND C

ASSETS		LIABILITIES AND CAPITAL	
A and B	24,000	A, Capital	12,000
C	15,000	B, Capital	12,000
		C, Capital	15,000
	<u>39,000</u>		<u>39,000</u>

In this case no agreement is made as to the capital ratios. A and B invest their old business at the book figures and C invests his \$15,000, not as a one-third interest in the assets, but as a contribution of so much capital. The Capital accounts on the balance sheet of A, B, and C, indi-

cate the capital ratio, and C's excess is given in consideration for the right to receive one third of the profits.

Valuation of Goodwill. A very frequent question arises as to how the value of goodwill is determined. There is no definite rule regarding the methods of determining the value of goodwill. The value will depend in the last analysis on what the purchaser is willing to pay for it.

In the past few years several methods of calculating the goodwill value have been used, as for example:

1. A certain number of times the last year's net profits has been used as a basis.
2. The average net profit for a number of years may be taken as a basis and multiplied by three, four, five, or any other agreed figure, and the result considered goodwill.
3. The average net earnings for a certain number of years may be taken and from this amount a return of eight per cent on capital, for instance, is subtracted. This result may be capitalized at ten, twelve and one half, or fifteen per cent and this value taken as the goodwill value.

These methods are arbitrary and are dependent upon acceptance by the purchaser before becoming final. The third case is the one which seems the most equitable. It has been accepted by the United States Income Tax Division in many cases to establish a goodwill value.

An example of this method follows:

The average earnings for 5 years are	\$20,000
Invested capital is \$150,000	
8% return on capital	<u>12,000</u>
Excess earnings above 8%	<u>8,000</u>
Capitalized at $12\frac{1}{2}\%$ ($\$8,000 \times 8$)	<u>\$64,000</u>
Capitalized at $16\frac{2}{3}\%$ ($\$8,000 \times 6$)	<u>\$48,000</u>

Using $12\frac{1}{2}$ per cent gives a value of \$64,000, for the goodwill and using $16\frac{2}{3}$ per cent gives \$48,000. These values serve as a definite bargaining basis. The final value will depend upon the circumstances of the situation. If it is a cash purchase the final figure will be lower than when the payment is to be made in capital interest in a business.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Explain what is meant by the phrase *admitting a partner to a partnership*.
2. What do you understand by the statement that *a business is liquidated potentially*?
3. In what two ways may a new partner be admitted to a partnership?
4. Explain the effect of each method on the capital of the new firm.
5. Explain the term *interest in the business*.
6. What is usually meant by the statement that a partner has a *one-half interest in a business*?
7. Define goodwill.
8. When is goodwill brought on to the books?
9. A has a capital of \$15,000 in a business. B agrees to put in \$20,000 provided A will admit him as an equal partner. Show entries to adjust the books.
10. A and B are partners, each having a Capital account of \$6,000. C is to become a partner with a one-third interest by investing \$7,000. Show entries bringing goodwill on the books and also entries where no goodwill is brought on the books.
11. When new books are opened for the partnership, how are the entries made?

12. When the old books are used, explain what entries should be made.
13. When goodwill is not recorded as an asset what effect does this have on the Capital account of the new partner?
14. Is there any rule for the definite determination of the value of goodwill?
15. Explain the methods illustrated in this chapter of calculating a value to be used as a basis for determining goodwill value.

CHAPTER XXVI

ADMISSION OF A PARTNER (*continued*)

BUYING AN INTEREST — INVESTING NEW CAPITAL

Admission of a Partner — Buying an Interest. As stated previously, the distinction between buying an interest and investing a sum to obtain an interest in a partnership should be noted.

Where the profit and loss ratio and capital ratio differ, there is all the more reason for careful analysis. The partnership agreement should differentiate between *capital ownership* and *profit and loss ownership* in all such cases.

When ownership in assets and in profits and losses are the same, not much difficulty arises as to the distribution of profits and losses and assets. If, however, these ratios differ, care must be taken to reflect proper capital interests so that no partner receives more than his share of profits and losses or of assets in event of dissolution.

For example, A and B as partners have Capital accounts showing A \$10,000, B \$5,000, and profits and losses are shared equally. C is to be admitted as a partner with a one-third interest in the profits and assets provided he pays to A and B a certain sum of money.

There are a number of possible agreements which may be made.

Case 1. Buying an Interest in a Partnership at Book Value. A and B may agree to sell C a one-third interest in the assets and profits for \$5,000 (no increase in capital). This may result in several capital ratios:

- (a) A may sell to C (B agreeing) \$5,000 of his capital, each partner then to share profits and losses equally.

C then pays to A \$5,000 and the books are adjusted as follows:

A, Capital	5,000	
C, Capital		5,000

To show admission of C according to agreement.

This results in A, B, and C having equal capital and equal profit and loss ratios. A receives \$5,000 because he is selling C \$5,000 of his capital.

(b) A and B may agree to each sell \$2,500 of their capital to C. This would result in the following adjustment:

A, Capital	2,500	
B, Capital	2,500	
C, Capital		5,000

To show admission of C in the partnership.

A and B would each receive \$2,500 from C for the capital sold by them.

The balance sheet would reflect the capital of the partners as follows:

BALANCE SHEET OF A, B, AND C

Assets	15,000	A, Capital	7,500
		B, Capital	2,500
		C, Capital	5,000
	<u>15,000</u>		<u>15,000</u>

The capital ratio would now be one half, one sixth, and one third for A, B, and C, respectively. The profit and loss ratio may be one third each or any other ratio agreed upon.

(c) A and B may agree to retain ownership in the same ratio as before. A and B own two thirds and one third of the capital respectively. A will retain two thirds of two-thirds ownership in the assets of the new business, B will retain one third of two thirds, and C will have one-third ownership in the assets.

This will result in the following ownership of the \$15,000:

A	$\frac{4}{9}$	\$6,666.67
B	$\frac{2}{9}$	3,333.33
C	$\frac{1}{3}$	5,000.00
		<u>\$15,000.00</u>

Entry to adjust:

A, Capital	3,333.33	
B, Capital	1,666.67	
C, Capital		5,000.00

To show admission of C in the partnership.

The profit and loss ratio may be one third each or any other ratio according to agreement. A and B each receive cash from C in the amount stated above for the capital sold to him.

The partnership agreement should definitely state what capital ratio should be used in the new firm. This would definitely settle which method should be used, one of the three illustrated above, or an arbitrary one due to a different agreement.

Case 2. Selling an Interest in a Partnership Above Book Value.

(a) *Goodwill not Recorded.* A and B may sell to C a one-third interest in the assets and capital for \$6,000. As the net assets of A and B are \$15,000 a one-third interest in the capital is worth \$5,000. As A and B are to receive \$6,000 for \$5,000 worth of assets there is a profit of \$1,000, which A and B will share equally.

The \$5,000 of capital may be sold by agreement in any of the following methods:

- (1) A may sell all of the \$5,000 from his capital.
- (2) A and B may each agree to sell \$2,500 capital.

- (3) A may sell to C two thirds of the \$5,000 and B one third, according to capital ratio.

Whichever agreement is made as to the capital to be sold to C, there is no increase in the firm capital.

An adjustment entry is made in the following form according to the plan used:

(1)

A, Capital	5,000.00	
C, Capital		5,000.00

To adjust Capital accounts on admission of C.

(2)

A, Capital	2,500.00	
B, Capital	2,500.00	
C, Capital		5,000.00

To admit C as a partner.

(3)

A, Capital	3,333.33	
B, Capital	1,666.67	
C, Capital		5,000.00

To admit C as a partner.

In each case the old partners would be repaid for the amount of their capital sold to C, and also receive \$500 each as profit from the \$6,000 paid over by C. No entry is made on the books for this part of the transaction as it is a private affair between A and B and C.

SUMMARY OF THE DISTRIBUTION TO A AND B OF C's \$6,000.00

	(1)	(2)	(3)
A receives	\$5,500.00	\$3,000.00	\$3,833.33
B receives	500.00	3,000.00	2,166.67
	<u>\$6,000.00</u>	<u>\$6,000.00</u>	<u>\$6,000.00</u>

(b) *Goodwill Recorded.* In the above illustration it may be desired to show goodwill. If one third of the business is sold for \$6,000, this may be said to place a value of \$18,000 on the business of A and B. As A and B have \$15,000 net assets the difference is \$3,000, which may be called goodwill and brought on to the books of A and B by the following entry:

Goodwill	3,000	
A, Capital		1,500
B, Capital		1,500

To record goodwill arising from
admission of new partner.

Entries for the admission of C would be as follows, using the three methods explained in the preceding illustration:

(1)

A, Capital	5,500	
B, Capital	500	
C, Capital		6,000

To admit C as a partner.

(2)

A, Capital	3,000	
B, Capital	3,000	
C, Capital		6,000

To admit C as a partner.

(3)

A, Capital	3,500	
B, Capital	2,500	
C, Capital		6,000

To admit C as a partner.

In the above three methods each one is dependent on the partnership agreement as to the ownership ratio of assets of A and B in the new partnership. The amounts shown

as debits to A and B represent the amount of cash each receives from C.

A summary of the capital ratios resulting under each of the above plans follows:

Partners	(1)	(2)	(3)
A	\$6,000	\$8,500	\$8,000
B	6,000	3,500	4,000
C	6,000	6,000	6,000
	<u>\$18,000</u>	<u>\$18,000</u>	<u>\$18,000</u>

Under Plan (1) all partners are to invest equal amounts. Under Plan (2) A and B invest unequal amounts resulting from the sale of equal parts of C's capital. Under Plan (3) A and B maintain the same respective capital ratio as before the admission of C. In any event C is a one-third partner by agreement.

In each case the profits and losses may be shared equally or in any other agreed ratio.

Case 3. Selling an Interest in a Partnership below Book Value. Should A and B agree to sell to C a one-third interest in the business for \$4,000, the following solutions are possible. In this situation A and B will each lose \$500 because they are selling \$5,000 worth of ownership for \$4,000.

- (a) If it is agreed to allow A to sell all the capital he would receive all of C's \$4,000 and sell \$4,500 worth of capital. B would sell \$500 of his capital and receive no money, thereby losing \$500.

The entry to adjust the books may be made as follows:

A, Capital	4,500.00	
B, Capital	500.00	
C, Capital		5,000.00

To adjust the Capital accounts.

(b) Where A and B sell equal amounts of capital the adjustment is as follows:

A, Capital	2,500.00	
B, Capital	2,500.00	
C, Capital		5,000.00

To adjust the Capital accounts.

A and B each receive \$2,000 from C, thereby losing \$500 each.

(c) Where A sells two thirds of the capital which C acquires and B one third, the adjustment is as follows:

A, Capital	3,333.33	
B, Capital	1,666.67	
C, Capital		5,000.00

To adjust the Capital accounts.

A would receive \$2,833.33 and B \$1,166.67 from C's \$4,000.00, losing \$500.00 each thereby.

A summary of the partners' capital under each plan follows:

Partners	(a)	(b)	(c)
A	\$5,500.00	\$7,500.00	\$6,666.67
B	4,500.00	2,500.00	3,333.33
C	5,000.00	5,000.00	5,000.00
	<u>\$15,000.00</u>	<u>\$15,000.00</u>	<u>\$15,000.00</u>

Goodwill Belonging to New Partner. There is also the possibility that the desirability of C as a partner may be such that A and B agree that C brings into the business some goodwill.

If this should be the case, the entries in the previous illustration would appear as follows:

(a) A, Capital	4,000.00	
Goodwill	1,000.00	
C, Capital		5,000.00

To show admission of C.

(b) A, Capital	2,000.00	
B, Capital	2,000.00	
Goodwill	1,000.00	
C, Capital		5,000.00

To adjust the Capital accounts.

(c) A, Capital	2,833.33	
B, Capital	1,166.67	
Goodwill	1,000.00	
C, Capital		5,000.00

To adjust the Capital accounts and admit C according to agreement.

Admission of a Partner—Investing New Capital. In the partnership of A and B, A's capital is \$10,000 and B's capital is \$5,000, and they share profits and losses equally.

In case C is to be admitted as a partner and invest assets which will give him a one-third interest in the business, the following considerations will govern the determination of the amount C is to contribute.

1. The book accounts may be taken as the true values. A balance sheet of the business of A and B would be used as a basis.
2. It may be that the assets are not worth their book value, and an agreement may be reached as to their proper valuation.
3. The business may be so profitable as to be considered worth more than the book value.
4. C may invest an arbitrary amount and obtain an interest in the profits and losses only.

Case 1. The net worth of A and B is \$15,000. As this is considered the true value, the amount C should invest is \$7,500. This would give him a one-third interest in the assets. The following entry meets all the accounting requirements:

Cash (or Assets)	7,500	
C, Capital		7,500

To admit C as a partner.

The firm capital would now be as follows:

A, Capital	10,000	
B, Capital	5,000	
C, Capital	<u>7,500</u>	
<u>Total</u>		<u>22,500</u>

Case 2. In this case it is necessary to place a new valuation on the assets of A and B. The following is the balance sheet of A and B.

A & B

BALANCE SHEET (Date)

ASSETS		LIABILITIES AND CAPITAL	
Cash	1,000	Notes Payable	3,000
Notes Receivable	2,000	Accounts Payable	8,000
Accounts Receivable	12,000	Mortgage Payable	7,000
Merchandise Inventory	6,000	A, Capital	10,000
Building & Equipment	<u>12,000</u>	B, Capital	<u>5,000</u>
	<u>33,000</u>		<u>33,000</u>

C is willing to contribute sufficient capital to make him a one-third owner, but first desires the assets revalued. The accounts receivable are investigated and it is estimated that \$1,000 will be uncollectible and that about \$500 of the merchandise inventory is shopworn and unsalable. These adjustments are accordingly made by the following entry:

A, Capital	750	
B, Capital	750	
Merchandise Inventory		500
Reserve for Bad Debts		1,000

To charge the partners with their proportionate share of decrease in value of assets due to revaluation.

This adjustment reduces the capital of A and B to \$13,500, which will now represent two thirds of the new capital. Consequently the amount C will invest will be equal to one half of this amount, or \$6,750. The new firm capital will now be:

A, Capital	9,250	
B, Capital	4,250	
C, Capital	<u>6,750</u>	
<u>Total</u>		<u>20,250</u>

It is understood that the agreement is that profits and losses are to be shared equally. It would be quite logical for A and C to request that interest be allowed on investments as a primary distribution of profits, and they may so agree, but any agreement is possible even the one stated.

Case 3. The old partnership may be in a position to demand and receive more than book value for a part of the business. The earning power may have been established through several years of successful operation. Conservative accounting may have kept asset values under market value.

Taking the same facts as in the problem under Case 2, \$7,500 would be sufficient investment in this case to make C a one-third partner. Suppose after due consideration of the facts and earning power it was agreed that C could obtain a one-third interest in the new firm for \$10,000.

- (a) The fact that a value of \$10,000 is taken for a one-third interest in the new partnership places a \$20,000 value on the two-thirds interest of the old partners A and B. In order that the books of A and B will show actual values turned over to the new partnership, the following adjustment may be made to bring the goodwill on to the books.

Goodwill	5,000	
A, Capital		2,500
B, Capital		2,500

To record the goodwill arising in
sale of the business.

Sale price	20,000
Book Value	<u>15,000</u>
Goodwill	5,000

C now invests \$10,000 and the new partnership Capital accounts are as follows:

A, Capital	12,500	
B, Capital	7,500	
C, Capital	<u>10,000</u>	
<u>Total</u>		<u>30,000</u>

- (b) In case no goodwill is brought on the books, C's capital would be one third of the total new capital of \$25,000, which is \$8,333.33. The balance would be credited to A and B, as owners of the goodwill sold, by the following entry:

Cash	10,000.00	
C, Capital		8,333.33
A, Capital		833.34
B, Capital		833.33

To show the investment of C and
distribute the amount paid for
one third of the goodwill.

The new firm capital will be represented as follows:

A, Capital	10,833.34	
B, Capital	5,833.33	
C, Capital	<u>8,333.33</u>	
<u>Total</u>		<u>25,000.00</u>

Case 4. In this case the partners are to allow C a one-third interest in the profits in consideration that he invest \$6,000. There is no intention of his being allowed any capital interest beyond the proportionate share which he contributes. Partners may have any capital ratio provided it is so agreed and still share profits and losses equally.

The capital ownership in this case would be represented by the Capital accounts as follows:

A, Capital	10,000	
B, Capital	5,000	
C, Capital	<u>6,000</u>	
<u>Total</u>		<u>21,000</u>

Partnership — Summary. From the preceding explanations and illustrations it will be seen that the problems in the admission of a partner are many and varied. The general problems of valuation of assets are very important as upon their appraisal depends the value of the capital of the individual partners at the beginning of the partnership.

If an asset is undervalued and later sold at a profit the partner contributing the asset loses, as he has to share the profits made with all the partners. For example, real estate is invested by a partner at appraised value of \$10,000. Later this asset is disposed of for \$15,000. If this asset was worth \$15,000 when invested by this partner, his Capital account should have been credited with \$15,000 instead of \$10,000. As it is he must now share the \$5,000 as a profit

with the other partners and will receive credit for his share of the profit only.

A clear distinction should be made between capital ownership ratios and profit and loss ownership ratios. The one is shown by the Capital accounts after closing; the other is according to agreement and has no relation, generally, to the capital ratio.

Goodwill may or may not be recorded on the books. It is generally recorded when purchased, but may be omitted if desired. It is owned by the partner or partners who are disposing of their business in the ratio of profit sharing which prevails at the time of the sale. Its value is a matter of agreement and depends on facts and circumstances surrounding the business.

One should be able to distinguish between buying an interest in a business and investing additional capital in a business. These and other problems require careful analysis and logical reasoning in order to arrive at a correct solution.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. When a new partner obtains an interest in a new partnership by buying an interest in the capital of the old partners, he may pay book value, more than book value, or less than book value. What happens to the money he pays?
2. How does the accounting treatment appear when the new partner pays more than book value?
3. What difference does it make whether goodwill is recorded on the books or not?
4. In what three ways may the old partners sell their capital to the new partner?
5. How do the old partners distribute to themselves the money paid by the new partner?

6. What considerations govern the determination of how much a new partner must invest to obtain an interest in a new partnership?
7. What is the importance of a proper valuation of the assets invested by a partner?
8. A has a capital of \$8,000, B a capital of \$6,000 and C is to buy a one-fourth interest in the assets and profits and losses for \$5,000. Show several possible solutions.
9. In Question 8 show the solution provided C is to invest \$5,000 for a one-fourth interest.
10. A and B are partners, each having a capital of \$6,000, and share profits and losses in the ratio A two thirds and B one third. C is to buy a one-third interest for \$7,000. Show a solution.
11. Suppose C invests \$7,000 to acquire a one-third interest. Show entries to adjust the books.

CHAPTER XXVII

PARTNERSHIP DISSOLUTION

Provision for Dissolution in Articles of Copartnership. The partners, at the time of the formation of the partnership, should include in the articles of copartnership a definite statement explaining the procedure to be followed in case of dissolution. In a voluntary dissolution the partners usually can agree to the procedure. In case of involuntary dissolutions, resulting principally from the death, insanity, or insolvency of any partner, there is no opportunity for agreeing upon the method of dissolution, unless it has been definitely settled in the original articles of copartnership. While it is true that the law provides a method for handling the interest of the partner causing the dissolution, yet, pending final disposition of this interest, the business may suffer severe financial losses which jeopardize not only the discontinuing partner's interest, but also the interests of the surviving partners.

Accounting Procedure for Dissolution. While the circumstances in each partnership dissolution differ, yet the procedure is so similar that the following general outline of the steps may be formulated:

1. Close the books of the partnership as of the date the partnership was dissolved, transferring any profit or loss to the accounts of the partners in accordance with their profit-and-loss-sharing ratio.
2. Convert all the assets into cash, charging any loss or crediting any gain from such conversion to a special Profit and Loss account, which may be called Loss and Gain on Realization and Liquidation. After all the assets have been converted this account is closed into the Partners' accounts in accordance with their regular profit-and-loss-sharing ratio.

3. Pay all outside creditors what is due them.
4. Pay the partners anything that the partnership owes them for loans, salaries, etc.
5. Distribute the remaining cash on hand to the partners according to the balances of their Capital accounts.

Inasmuch as the assets of a partnership, in the absence of any provision to the contrary, are distributed in the proportion of the Capital accounts, it is essential that any losses or gains be carried to the partners' accounts before any assets are distributed. The Capital accounts will then exhibit the correct interests at the time of distribution. This provision should be observed when any distribution of assets is made (excepting assets representing profits), whether the business is to be dissolved or not. Occasionally the partners may find that the business is overcapitalized and agree to reduce the capital. The amount of capital withdrawn should be distributed to the partners in proportion to their Capital accounts, adjusted by all profits and losses.

Problem Illustrating Dissolution of a Partnership. The partnership of Aiken and Murch is to be dissolved by mutual agreement of the partners. Profits and losses are shared equally. The books have been closed as of April 30, 19—, and the following balance sheet was prepared therefrom:

AIKEN & MURCH

BALANCE SHEET AS AT APRIL 30, 19—

ASSETS		LIABILITIES AND CAPITAL	
Cash	2,500	Accounts Payable	8,400
Accounts Receivable	13,250	Notes Payable	1,500
Notes Receivable	2,000	Murch, Loan	2,000
Inventory	3,750	Aiken, Capital	6,800
Furniture & Fixtures	1,200	Murch, Capital	10,000
<u>Total</u>	<u>28,700</u>	<u>Total</u>	<u>28,700</u>

In the process of liquidation the accounts receivable realized \$10,400; the notes receivable realized \$2,000; merchandise inventory realized \$7,500. Furniture and fixtures sold for \$500.

The following entries record the above information on the books of Aiken and Murch:

(1)

Cash	20,400	
Accounts Receivable		10,400
Notes Receivable		2,000
Merchandise Inventory		7,500
Furniture and Fixtures		500

 To record the sale of the above
assets.

(2)

Loss and Gain on Realization and Liquidation	5,800	
Accounts Receivable		2,850
Merchandise Inventory		2,250
Furniture and Fixtures		700

 To record the losses realized by
the sale of the assets.

(3)

Aiken, Capital	2,900	
Murch, Capital	2,900	
Loss and Gain on Realization and Liquidation		5,800

 To record in the Capital accounts
the loss on sale of assets.

The following balance sheet shows the condition of the business previous to final liquidation:

AIKEN & MURCH

BALANCE SHEET AS AT

ASSETS		LIABILITIES AND CAPITAL	
Cash	22,900	Accounts Payable	8,400
		Notes Payable	1,500
		Murch, Loan	2,000
		Aiken, Capital	3,900
		Murch, Capital	7,100
<u>Total</u>	<u>22,900</u>	<u>Total</u>	<u>22,900</u>

The following is the procedure in the order in which legally it should be performed: First, pay all the outside creditors in full; next, pay the partners' Loan accounts; and then, distribute the balance remaining to each partner according to the balance of his Capital account.

The entries for the above will close all the accounts on the books and are as follows:

(1)

Accounts Payable	8,400	
Notes Payable	1,500	
Cash		9,900
To show payment of creditors in full.		

(2)

Murch, Loan	2,000	
Cash		2,000
To record payment of the loan to Mr. Murch.		

(3)

Aiken, Capital	3,900	
Murch Capital	7,100	
Cash		11,000
To distribute the balance due each partner in final liquidation.		

The plan of liquidation shown above illustrates the procedure in a partnership dissolution. In actual liquidation problems the work may extend over a long period of time, and many complicated problems may arise. The procedure in all cases is practically the same, but the problems of accounting details will vary.

A somewhat more complicated liquidation is illustrated in the following problem. This problem requires a more detailed analysis of the partners' interests, and shows a situation where one partner is unable to make good for losses in liquidation.

Problem Illustrating Dissolution of a Partnership — One Partner Insolvent. The partnership of Smith, Shaw & Jones is to be dissolved as of December 31, 19—, by mutual agreement of all the partners. The partners shared profits and losses as follows: Smith, 60 per cent; Shaw, 30 per cent; and Jones, 10 per cent. The books have been closed as of December 31, 19—, and the following condensed balance sheet prepared therefrom:

SMITH, SHAW & JONES			
BALANCE SHEET AS AT DECEMBER 31, 19—			
ASSETS		LIABILITIES AND CAPITAL	
Cash		Accounts Payable	25,000
Accounts Receivable	19,000	Notes Payable	10,000
Less — Reserve for Loss	800	Mortgage Payable	12,000
Notes Receivable		Shaw, Loan	6,000
Merchandise Inventory	75,000	Jones, Salary	3,000
Land	4,000	Smith, Capital	12,000
Buildings — Cost	28,000	Shaw, Capital	60,000
Less — Depreciation Reserve	5,600	Jones, Capital	6,100
Furniture and Equipment — Cost	9,000		
Less — Depreciation Reserve	4,500		
Total	134,100	Total	134,100

The assets were disposed of as follows:

Accounts receivable collected, \$15,400. The balance is

uncollectible. Notes receivable collected, \$7,000. Merchandise inventory sold for \$50,000.

Land and buildings sold, subject to the mortgage, for \$18,000. Furniture and equipment sold for \$2,000.

The following entries record the disposition of the assets:

(1)

Cash	15,400	
Reserve for Loss on Bad Accounts	800	
Loss and Gain on Realization and Liquidation	2,800	
Accounts Receivable		19,000
To record settlement of customers' accounts.		

(2)

Cash	7,000	
Notes Receivable		7,000
To record payment of notes receivable.		

(3)

Cash	50,000	
Loss and Gain on Realization and Liquidation	25,000	
Merchandise Inventory		75,000
To record sale of merchandise.		

(4)

Cash	18,000	
Mortgage Payable	12,000	
Depreciation Reserve on Buildings	5,600	
Land		4,000
Buildings		28,000
Loss and Gain on Realization and Liquidation		3,600
To record sale of land and buildings.		

(5)

Cash	2,000	
Depreciation Reserve on Furniture and Equipment	4,500	
Loss and Gain on Realization and Liquidation	2,500	
Furniture and Equipment		9,000
To record sale of furniture and equipment.		

After these entries the Loss and Gain on Realization and Liquidation and the Cash accounts would appear as follows:

Loss and Gain on Realization and Liquidation			
Accounts Receivable	2,800	Land and Buildings	3,600
Merchandise Inventory	25,000		
Furniture and Equipment	2,500		
	<u>30,300</u>		

Cash	
Balance	3,000
Accounts Receivable	15,400
Notes Receivable	7,000
Merchandise	50,000
Land and Buildings	18,000
Furniture and Equipment	2,000
	<u>95,400</u>

The Loss and Gain on Realization and Liquidation account is now closed into the partners' Capital accounts by the following entry:

Smith, Capital	16,020
Shaw, Capital	8,010
Jones, Capital	2,670
Loss and Gain on Realization and Liquidation	26,700

To close the loss on conversion of assets into the Capital accounts as follows:

Smith, 60% of \$26,700 = 16,020

Shaw, 30% of \$26,700 = 8,010

Jones, 10% of \$26,700 = 2,670

After this entry is posted the Capital accounts would appear as follows:

Smith, Capital		
Share of Loss on Conversion of Assets	16,020	Balance 12/31/— 12,000
Shaw, Capital		
Share of Loss on Conversion of Assets	8,010	Balance 12/31/— 60,000
Jones, Capital		
Share of Loss on Conversion of Assets	2,670	Balance 6,100

After charging Smith, Capital with his proportionate share of the loss, his account shows a debit balance of \$4,020. Inasmuch as he agreed to share 60 per cent of the

profits or losses he is bound to contribute to the partnership the amount of the debit balance, if he has money or property to do so. An investigation discloses that Smith has absolutely no assets of value to make up this deficiency. In this case the amount becomes an additional loss which must be borne by Shaw and Jones in accordance with their profit-and-loss-sharing ratio. Their original basis was three tenths and one tenth respectively, which now, in order to absorb the loss resulting from the insolvency of Smith, must be changed to 75 per cent and 25 per cent; that is, the ratio of 3 to 1.

The following entry is made to close Smith's account and to transfer the loss resulting therefrom to Shaw and Jones:

Shaw, Capital	3,015	
Jones, Capital	1,005	
Smith, Capital		4,020

To record loss through insolvency
of Smith.

The Capital account of Smith is now closed and the accounts of Shaw and Jones will appear as follows:

Shaw, Capital		
Share of Loss on Conversion of Assets	8,010	
Share of Smith's Unpaid Debit Balance	3,015	
		Balance 12/31/— 60,000

Jones, Capital		
Share of Loss on Conversion of Assets	2,670	
Share of Smith's Unpaid Debit Balance	1,005	
		Balance 12/31/— 6,100

The following balance sheet prepared after the liquidation of the assets and the adjustment of the Capital accounts through losses shows the condition of the Liability and Capital accounts. These are now settled according to the procedure outlined below.

SMITH, SHAW & JONES			
BALANCE SHEET AS AT DECEMBER 31, 19—			
ASSETS		LIABILITIES AND CAPITAL	
Cash	95,400	Accounts Payable	25,000
		Notes Payable	10,000
		Shaw, Loan	6,000
		Jones, Salary	3,000
		Shaw, Capital	48,975
		Jones, Capital	2,425
<u>Total</u>	<u>95,400</u>	<u>Total</u>	<u>95,400</u>

The creditors outside of the business are now paid in full, which payment may be recorded by the following entry:

Accounts Payable	25,000	
Notes Payable	10,000	
Cash		35,000

To record payment of creditors.

The amounts which the partnership owes the partners individually would next be paid and this would be recorded by the following entry:

Shaw, Loan	6,000	
Jones, Salary	3,000	
Cash		9,000

To record payment of liabilities to partners.

The cash remaining undistributed now amounts to \$51,400, which is just equal to the sum of the balances in Shaw and Jones's Capital accounts, which are \$48,975 and

\$2,425 respectively. The following entry is now made to distribute the remaining cash to Shaw and Jones in proportion to their present interests:

Shaw, Capital	48,975	
Jones, Capital	2,425	
Cash		51,400

To record final liquidation of
partnership.

After this entry is posted all the accounts of the partnership are in balance and closed.

Loss on Realization and Liquidation Charged to Partner Having no Investment Account. It may happen that one of the partners has an interest only in the profits and losses of the business, and, therefore, has no Capital account. A loss incurred in the dissolution of a partnership would be charged to him in accordance with his profit-and-loss-sharing ratio. If he has any private assets, he can be required by law to contribute the amount of such loss to the partnership. If he has no property which can be reached by the partnership, this loss becomes an additional loss for the other solvent partners.

Notice of Dissolution of Partnership. Partners should notify all the persons with whom they have done business of the dissolution in order to escape possible further liability. This is best done by sending out individual notices to each and every person with whom the partnership has had dealings. A notice of the dissolution should be inserted in the newspapers of the city or town in which the partnership conducted its business.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. In what ways may a partnership be dissolved?
2. A, B, and C were members of a partnership and agreed to dissolve. During the operation of the partnership they shared profits as follows: A, 60 per cent; B, 30 per cent; and C, 10 per cent. In converting the assets into cash a loss amounting to \$12,000 was sustained. A contends inasmuch as the partnership was dissolved prior to the conversion of the assets, this cancelled the agreement for sharing profits or losses and therefore the loss sustained in the conversion of assets should be borne equally.
3. Ray, Kay, and Day were partners sharing profits in the ratios of 50 per cent, 30 per cent, and 20 per cent respectively. They decide to dissolve and a loss of \$18,000 results from the conversion of the assets. Upon charging Kay and Day with their proportionate share of this loss, Kay's Capital account shows a debit balance of \$2,000. Kay has no other assets. What becomes of this debit balance in Kay's account?
4. Give the order in which the creditors are paid in a partnership dissolution.
5. Why should the partners' accounts be charged with all losses or credited with all gains before any distribution is made of assets?
6. Why should partners send out notices of the dissolution of a partnership to all with whom the business has had dealings?

CHAPTER XXVIII

TYPES OF BUSINESS ORGANIZATION

Ordinary Types of Business Proprietorship. The development of accounting principles in this text has been based on the equation

$$\text{Assets} - \text{Liabilities} = \text{Proprietor's Capital}$$

In the previous chapters, emphasis has been placed on the first two terms of this equation, namely, the Assets and Liabilities. In this chapter the Proprietor's Capital or the Capital term of the equation will be discussed to the extent of the ordinary types of proprietorship.

The two types of proprietorship already used, namely, the single proprietorship and the partnership, are reviewed in this chapter in order to compare them in certain respects with another type of proprietorship, called the *Corporation*, which is introduced in this chapter.

Single Proprietorship. In the single proprietorship, the entire excess of assets over liabilities belongs to one individual; also, the results of operating the business belong to him alone. This type of business proprietorship is formed or terminated without any formalities, legal or otherwise, and is operated in accordance with the sole judgment or desires of this individual.

The individual owner of a business owns each dollar of profits as it is earned and he also must bear all the losses of the business. He risks, in the business, not only his investment, but also his private assets. The law does not recognize the business of an individual as distinct from the indi-

vidual. Consequently, an individual owner of a business actually risks in his business, not only the assets invested in the business, but practically everything he owns.

Partnership. In a partnership the excess of assets over liabilities belongs to the partners in accordance with their interests as reflected by their Capital accounts. A partnership is based on a contract, express or implied, between the partners, and this contract is the guide as to what the partners may or may not do in matters of partnership interest.

The operation of the partnership is a personal matter between the partners, and the law does not interfere in or attempt to regulate its operation as long as its business is legal. The partners, based on their original contract, or upon subsequent agreements, have entire freedom of action in partnership affairs. They are free to change or rescind the contract by agreement between themselves at any time.

Except for special purposes the law does not recognize the partnership as an entity existing separately from the partners, but considers the partnership as being composed of individuals who have pooled their resources for a common interest. For this reason, the liability of a partner with respect to partnership liabilities is similar to the liability of a sole proprietor; each partner is individually and jointly liable for the liabilities of the partnership to the full extent of both the partnership assets and their private assets.

One of the essential characteristics of a partnership is the co-ownership by the partners of the profits, as they are made, in the ratio specified in the articles of copartnership or, in the absence of agreement, as implied by law. The profits may be withdrawn by the copartners or left in the business in accordance with the wishes of the partners.

Not only may the profits be withdrawn at will by the partners, but also their original capital may be withdrawn without legal interference, unless the creditors, whose interests may be jeopardized, seek the protection of the court.

A partnership may be terminated by a provision in the articles of copartnership or by subsequent agreement of the partners. The death, insanity, or insolvency of any of the partners also terminates the partnership.

Corporation. A corporation is a form of proprietorship which results from the association of individuals in compliance with the law of a particular State, by which a separate legal entity is created for some particular purpose or purposes. The law creates an artificial person in the name of the corporation which exists separately from the members who compose it, and which is empowered to do practically everything that a natural person may do.

Since corporations are creatures of the law, they have only such rights and powers as are given to them by the laws of the State under whose laws they are incorporated. The State also prescribes obligations and restrictions upon the corporation and exercises a certain supervision over its activities through the periodic reports which the corporation is required to file.

Procedure for Incorporation. The laws of most States require that three or more persons, called *incorporators*, initiate the formation of the corporation. Usually, at least one of the incorporators must be a citizen of the State of incorporation.

The incorporators meet and draw up articles indicating the purpose, the name, the beginning capital, and other details of the proposed corporation. By-laws are adopted

and officers prescribed by law are elected. The required papers are then filed with the proper State authority, who, after approval of the proposed incorporation and payment of the statutory fee, authorizes the creation of the corporation by filing the papers and issuing a charter of incorporation.

The by-laws are the general rules of corporate action drawn up and adopted by the stockholders, which must not conflict in any way with the State statute, which is the primary source of authority, nor with the charter, which is the specific authorization for corporate existence. A corporation is, therefore, regulated by the statutes of the State of incorporation, by the charter issued by the State, and by the by-laws of the corporation approved by the stockholders.

Management of the Corporation. The management of a corporation is in the hands of a board of directors who are elected by the stockholders in the manner prescribed in the by-laws of the corporation. The number of directors is fixed by the by-laws and varies from three to any number. The directors are usually stockholders, but the by-laws may permit the election of directors who are not stockholders.

The directors may elect certain officers in accordance with the by-laws. The directors usually elect the president, vice-president, general manager, and sometimes the treasurer. The laws of many of the States require the election of the treasurer and the clerk or secretary by the stockholders.

The duties of the directors and officers elected by the stockholders are fixed by law, and are usually specifically defined in the by-laws. The duties of the officers elected by the directors are also specified in the by-laws of the cor-

poration. The duties of such officers vary widely, depending upon the size of the corporation.

The principal officer, from the viewpoint of the State, is the secretary or clerk. This officer is custodian of the corporate seal, records all corporate action taken at stockholders' meetings in a record called the *Minute Book*, takes care of the corporate records and the issue of stock, and, in brief, acts as the official representative of the corporation in all its official corporate acts.

Capital. The term *capital* is used in business with varying meanings. In this text, it has been used synonymously for net worth or proprietor's capital. While the term *capital* is used in economics with a slightly different meaning and is used in business to refer to the total value of the money and property owned by a business, yet it seems best to continue to restrict the use of the word *capital* to the excess of the assets over liabilities.

Capital Stock. A corporation is authorized by law, at the time of formation or upon subsequent application, to issue to the owners or contributors of the capital evidences of ownership called *certificates* or *shares of capital stock*. The total amount of capital stock which a corporation is authorized to issue by the State is called *authorized capital stock*. It is merely the total amount of stock which the corporation may legally issue. This authorized stock is usually issued upon receipt of payment in full, and the amount of such stock is called the *issued stock*. The amount of the authorized stock which is not issued is called *unissued stock*.

Corporations usually are allowed to reacquire their own issued stock. The capital stock of a corporation which has been fully paid for and issued, and which is subsequently reacquired by that corporation by purchase, or by gift, is

called *treasury stock*. The difference between treasury stock and unissued stock should be carefully noted. Unissued stock is the amount of the authorized stock which has never been issued, while treasury stock is a portion of the authorized stock which has been issued, fully paid for, and subsequently reacquired by the corporation.

When the term *capital stock* is used without qualifying adjectives in this text, it means issued capital stock.

Shares of Capital Stock. The capital stock of a corporation is divided into equal parts called *shares*. The shares of stock are represented by certificates indicating the number of shares, and are the evidences of the ownership of a proportionate part of the capital of the corporation. The owners of the shares are called *stockholders*.

The certificates of stock are made out in the name of the owner and are transferable by him by indorsement in the prescribed manner. Such stock is then sent to the corporation or its transfer agent for the recording of the transfer and the issue of a new certificate. The owner of stock, according to the records, is called the *stockholder of record* of the corporation, and is entitled to all the rights and privileges granted to the stock which he holds.

Capital and Capital Stock Distinguished. Capital as previously defined is the difference between the assets and liabilities, i.e. net worth. This net worth includes the paid-in capital as well as earnings left in the business. Capital stock represents the amount of capital paid in for the issued stock. In most cases it reflects only the original or paid-in capital of the corporation. The earnings of a corporation which are allowed to remain in the business are recorded in a separate account called *Surplus*.

The capital of a corporation is, therefore, the sum of its

capital stock and surplus, or, in case of losses, the capital stock minus the amount of the losses called the *deficit*.

Par Value Capital Stock. The corporation may be authorized to issue shares of stock of a certain specified value called *par value*. This par value is specified by charter and is printed on each certificate of stock and indicates the amount which should be paid for each share at the time of original issue. The laws of most States define what may be accepted in payment for stock at the time of original issue.

The real significance of par value, therefore, is that it represents, at the time of original issue, the amount which should have been paid into the corporation in money, property, or other value. The amount of the par value may be any amount, but it is usually \$100.00 or some aliquot part thereof.

The laws of many States expressly prohibit the sale of stock of original issue below par value, and, in case stock is issued contrary to this provision, the difference between the par value and the amount actually paid may be later collected from the stockholder. It should be noted that this applies only to stock of original issue having a par value. It does not apply to treasury stock, which may be sold for any amount at the will of the corporation.

No-Par Value Capital Stock. In recent years, many States have authorized corporations to issue stock without bearing any specific value, which is called *no-par value stock*. The corporation, at the time of issue, determines the price at which it is to be sold, and this amount represents the paid-in capital of the corporation. The charter of such corporations merely specifies the number of shares and the kind of stock which the corporation may issue.

The capital stock of a corporation issuing no-par value stock represents the capital paid in for the issued stock at the prices fixed by the corporation at the time of the sale. Whether the stock is par value or no-par value, the ownership of the corporation is represented by the shares of the stock outstanding. In other words, the ownership of the corporation is represented by the number of shares of the issued and outstanding capital stock.

Control of Earnings — Dividends. The stockholders or owners of a corporation, unlike the owner of a single proprietorship or the partners in a partnership, have no proprietary right in the earnings of the corporation until the directors elected by the stockholders have definitely voted to pay a certain amount of the earnings to the stockholders, called the *declaration of a dividend*.

A dividend may be defined as a distribution of the earnings of a corporation, to its stockholders in proportion to their holdings, which has been authorized by the vote of the directors at a regular or special meeting properly called.

The stockholders have no enforceable right to the earnings of a corporation until the directors have declared a dividend. The amount of such a dividend then becomes a liability of the corporation. A dividend, therefore, presupposes (1) earnings and (2) a vote of the directors distributing a portion of the earnings to the stockholders entitled thereto.

The laws of most States impose a serious responsibility upon the directors of corporations, making them personally liable for dividends which are not paid out of earnings or for assenting to a dividend which renders the corporation insolvent.

Classification of Capital Stock. The capital stock of a corporation may be classified according to the rights and limitations pertaining thereto, as follows:

Common stock
Preferred stock
Guaranteed stock, etc.

Common stock is that class of stock which has no special privileges or rights, but which is entitled to whatever capital or surplus remains after the claims of the preferred or special classes of stock have been satisfied. Common stock may be further divided into different classes, because of some limitation, usually of voting powers.

The common stock usually carries the voting right, each share being entitled to one vote at the meetings of the stockholders.

Preferred stock (it is defined as capital stock entitling the holder thereof to some preference) may be further subdivided as follows:

Cumulative preferred stock
Non-cumulative preferred stock
Participating preferred stock
Non-participating preferred stock

Cumulative preferred stock entitles the holder thereof to a specified dividend *each year* before the common stockholders are entitled to any dividend. If the corporation does not pay this dividend on the preferred stock in any year, the amount of the dividend must be paid in the subsequent year or years before any dividend can be paid to the common stockholders.

Non-cumulative preferred stock entitles the holder to a specified rate of return only when and if paid by the cor-

poration. If this specified rate is not paid in any year, the corporation need not pay it in subsequent years.

Participating preferred stock entitles the holder thereof to a specified rate of return, and, in addition, to share with the common stockholders in any dividends in excess of the specified rate.

Non-participating preferred stock entitles the holder to the specified rate only without participation in the distributions in excess of this rate.

Preferred stock may also be Cumulative and Participating Preferred Stock.

Guaranteed Stock. Guaranteed stock is the capital stock of one company which is guaranteed, usually as to dividend and occasionally, also, as to principal, by another company. A company cannot guarantee its own stock, because the laws of most States permit the payment of dividends to stockholders only from earnings, but another company can guarantee to pay a specified rate of return on the stock. To illustrate, the A Company guarantees the dividends of Company B, in order that Company B may secure capital to produce an article which Company A needs for its own business. If Company B fails to pay its dividends, Company A would be obligated, because of its guaranty to do so.

Corporate Accounts Relating to Capital and Dividends. The functions of some of the corporate accounts which relate to the capital of a corporation and dividends are explained in the following paragraphs.

CAPITAL STOCK — COMMON OR PREFERRED

A separate account is usually kept for each class of stock

Debited:	Crèdited:
For par value of shares having a par value which have been repurchased by the corporation for retirement in accordance with an amendment to its charter authorizing such a reduction.	For par value of shares having a par value which are issued.
or:	or:
For original sales value of shares having no-par value which have been repurchased by the corporation for retirement in accordance with an amendment to its charter authorizing such a reduction.	For the amount actually received from the sale of shares of no-par value authorized stock when such shares are issued.

The balance of this account is a credit and represents the amount of the authorized stock which has been issued.

CAPITAL SURPLUS

Debited:	Credited:
For the amount paid over par value, or over issuing value for the retirement of issued stock.	For excess of paid-in capital over par value of shares issued.
For losses resulting from revaluation of assets.	For surplus originating from revaluation of assets.
For losses on sale of Treasury Stock.	For profits on sale of Treasury Stock.
	For profit on stock cancelled below par value.

The balance of this account is usually a credit and represents that portion of the surplus of a corporation which is in the *nature* of capital *but should not* be used to pay dividends.

EARNED SURPLUS

Debited:	Credited:
For net loss for period as shown by the Profit and Loss account.	For the net profit for the period as shown by the Profit and Loss account.
For items of expense or losses belonging to prior periods.	For items of income belonging to prior accounting periods, or for the recovery or adjustment of expenses or losses of prior periods.
For dividends declared by the directors.	

The balance of this account, if a credit, represents the earnings of the corporation available for dividends. If a debit, it represents a deficit, or an impairment of the Capital Stock value as reflected by that account.

DIVIDENDS PAYABLE

Debited:	Credited:
For the amount of payments made on dividends which have been declared; the corresponding credit is to cash or other asset.	For the amount of dividends declared by the directors; the corresponding debit is to Surplus.

The balance of this account, if any, is a credit and represents the liability of the corporation to the stockholders for unpaid dividends.

Records of a Corporation. The books of account of a corporation are practically the same as the books of any business, but, in addition to the financial books which record the transactions, the corporation keeps books to record the names and addresses of the stockholders, the proceedings of the stockholders' and directors' meetings, a dividend record, and other books for the recording of its peculiar corporate activities. The laws of most States require the keeping of a minute book to record the proceedings of the stockholders' and directors' meetings, and stock

records which show the names of the stockholders, the amount of stock owned, and the total issued stock.

As stated previously, the names of the stockholders do not appear on the General Ledger, merely the total amount of the issued stock being shown in the Capital Stock account. This account is, therefore, a controlling account for the Stockholders' Ledger. The balance of the Capital Stock account should be equal to the total of the stock standing to the credit of the stockholders in the Stockholders' Ledger.

Characteristics of a Corporation. A summary of some of the more important characteristics of a corporation is as follows:

- (1) Creation by law.
- (2) Separate legal entity with a proper name.
- (3) Controlled by
 - (a) the State statute by which created;
 - (b) charter issued by the State;
 - (c) by-laws adopted by the stockholders.
- (4) Continuity of existence independent of life or lives of stockholders and officers.
- (5) A distinctive corporate seal.
- (6) Limitation of stockholders' liability to investment in the corporation.
- (7) Management by a board of directors elected by the stockholders.
- (8) Obligation to keep certain records.
- (9) Obligation to file reports required by the State some of which are public.
- (10) Ownership of corporation represented by transferable shares.
- (11) Limitation of activity to purpose for which the corporation was formed.

Corporate Balance Sheet. The following balance sheet is illustrative of a corporate balance sheet.

A. R. JONES, INC.

BALANCE SHEET AS AT DECEMBER 31, 19—

Current Assets:			
Cash		\$6,800.00	
Accounts Receivable	\$18,000.00		
Less: Reserve for Bad Debts	<u>2,100.00</u>	15,900.00	
Notes Receivable		8,700.00	
Merchandise Inventory		<u>28,000.00</u>	\$59,400.00
Fixed Assets:			
Land		4,000.00	
Building	40,000.00		
Less: Depreciation Reserve	<u>2,000.00</u>	38,000.00	
Furniture and Equipment	12,000.00		
Less: Depreciation Reserve	<u>3,000.00</u>	<u>9,000.00</u>	51,000.00
Deferred Charges:			
Prepaid Insurance		680.00	
Office Supplies		<u>220.00</u>	900.00
Total Assets			<u><u>\$111,300.00</u></u>

LIABILITIES AND CAPITAL

Current Liabilities:			
Accounts Payable		\$8,000.00	
Notes Payable		4,000.00	
Dividends Payable — Preferred Stock		<u>1,400.00</u>	\$13,400.00
Fixed Liabilities:			
Mortgage Payable		<u>\$20,000.00</u>	20,000.00
Total Liabilities			33,400.00
Capital:			
Capital Stock			
Authorized 7% Preferred Stock —			
500 shares @ \$100	\$50,000.00		
Less: Unissued — 300 @ \$100	<u>30,000.00</u>		
Issued and Outstanding		20,000.00	
Authorized Common Stock —			
600 shares @ \$100	60,000.00		
Less: Unissued Common — 200 shares @ \$100	<u>20,000.00</u>		
Issued and Outstanding — 400 shares @ \$100		40,000.00	
Surplus		<u>17,900.00</u>	77,900.00
Total Liabilities and Capital			<u><u>\$111,300.00</u></u>

Analysis of Surplus. It is customary to submit with the balance sheet of a corporation a statement showing an analysis of the surplus. The following is the analysis of Surplus of the A. R. Jones, Inc., as of December 31, 19—.

A. R. JONES, INC.

SURPLUS ANALYSIS AS AT DECEMBER 31, 19—

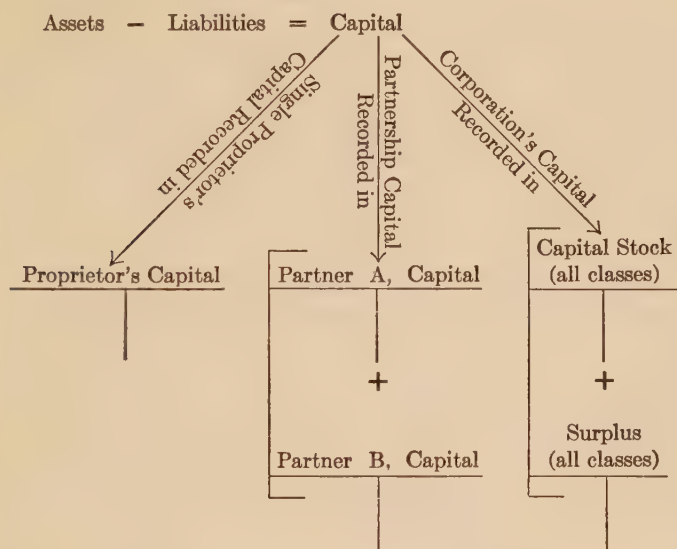
Surplus balance as of January 1, 19—		\$6,480.00
Deduct:		
Dividends paid, at the rate of 6% on Common Stock, July 1, 19—	\$2,400.00	
Dividends declared on 7% Preferred Stock, December 15, 19—	<u>1,400.00</u>	3,800.00
Add:		
Net Profit for the year ending December 31, 19—		15,220.00
Surplus balance as of December 31, 19—		<u><u>\$17,900.00</u></u>

Net Worth of the Corporation. It should be observed that the balance sheet of the corporation differs from the balance sheet of any other business only in the showing of the capital or the net worth of the business. In the balance sheet of the A. R. Jones, Inc., the net worth of the corporation is the sum of the following:

Issued Common Stock — 400 shares @ \$100	\$40,000.00
Issued 7% Preferred Stock — 200 shares @ \$100	20,000.00
Surplus	<u>17,900.00</u>
Net Worth of the Corporation	<u><u>\$77,900.00</u></u>

The Capital section of a corporation balance sheet should show the amount of capital paid in, the rights of each class of stockholders therein, and the accumulated earnings which are held in the business. Separate accounts with each capital element are maintained in the Ledger, and each account is shown in the Capital section of the balance sheet, in whatever detail desired.

Summary of Capital Ownership. The ownership of the capital term of the balance sheet equation is summarized in the following chart.



The purpose of this summary is to emphasize that the first two terms of the equation, namely, assets and liabilities, are not necessarily different in the three types of ownership and that the difference between the assets and liabilities always represents the equity of the owner or owners of the business irrespective of the type of proprietorship.

Comparison of Single Proprietorship, Partnership and Corporation. The accompanying chart presents in a comprehensive form some of the differences between the three types of proprietorship presented up to this point.

	Single Proprietorship	Partnership	Corporation
Formation	Investment by proprietor.	Contract of copartnership.	Compliance with the legal requirements of the State.
Legal Aspect of	No separate entity.	No separate legal entity.	Separate legal entity
Activities regulated by	Will of proprietor.	Agreement of partners.	Statutes of State, Charter of Corporation, By-laws of Corporation.
Management in control of	Proprietor.	Partners.	Board of Directors elected by stockholders.
Liability of owners	Liable to full extent of all assets, both business and private, for debts of business.	Partners liable individually and jointly for firm indebtedness to extent of all assets, both business and private.	Stockholders not individually liable for debts of corporation.
Equity of owners represented on books by	Proprietor's Capital accounts.	Partners' Capital accounts.	Capital Stock (all classes). Surplus (all classes).
Ownership of real property	In name of proprietor.	In the name or names of partners, individually.	In the name of the corporation.
Ownership transferred by	Sale of net assets.	Sale of partner's interest or sale of net assets.	Transfer of shares of stock of corporation, or sale of net assets.
Business terminated by	Act of proprietor.	Agreement between partners, also, by death, insanity or insolvency of partners, or legal action.	Act of legislature of State of incorporation, or vote of two thirds of shares of stock.
Interest in profits	Proprietary interest in each dollar of profits as earned.	Proprietary interest in each dollar of profits as earned.	Stockholders have no enforceable claim in profits until a dividend is declared by directors.
Salaries of owners	Treated as distribution of earnings.	Treated as distribution of earnings.	Treated as an expense of the corporation.
Withdrawal of capital	Will of proprietor.	Agreement of partners.	Authorized by amendment, either dissolving or reducing the capital of the corporation, upon vote of stockholders.
Power to sue or be sued	Suit brought by proprietor.	Suit brought by partners individually.	Suit brought by corporation in its own name.

MATERIAL FOR CLASS DEMONSTRATION AND
DISCUSSION

1. (a) Give the advantages of an individual proprietorship.
(b) Give the disadvantages of an individual proprietorship.
2. (a) Give the advantages of a partnership.
(b) Give the disadvantages of a partnership.
3. What are the salient *differences* between a partnership and a corporation?
4. How is a corporation formed?
5. Name and give the duties of the officers responsible for the management of a corporation.
6. Distinguish between capital and capital stock.
7. Define authorized capital stock, unissued capital stock, and treasury stock.
8. (a) What is a share of capital stock?
(b) How may shares of stock be transferred?
9. What is the significance of a specified value called par value on a certificate of stock?
10. How would the authorized capital of a corporation having no-par value shares be stated?
11. How would the authorized capital of a corporation having par value shares be stated?
12. Define a dividend.
13. What are a director's responsibilities in regard to a declaration of dividends?
14. Define capital surplus. Distinguish between capital surplus and earned surplus.
15. Compare the different types of organization listing as many differences as possible.

CHAPTER XXIX

SINGLE ENTRY BOOKKEEPING PROCEDURE

Double Entry versus Single Entry. As defined previously, double entry bookkeeping is the system of recording transactions which requires equal debits and credits for every transaction. This system is based on the balance sheet equation, and, because of the double entry, the equation is always in balance. This plan of recording necessitates the use of all classes of accounts, both real and nominal.

There is another method of recording transactions which is sometimes used, called Single Entry.

In this method accounts are maintained in the Ledger only with debtors, creditors, and the proprietor. In other words, the only asset accounts which are kept are the Accounts Receivable; the only liability accounts are the Accounts Payable, and an account is kept with the Proprietor. No Nominal accounts are kept, as a general rule.

In recording transactions a debit or a credit is made only if an account with a person or firm is affected. All other transactions are merely entered as an historical record without analysis.

Single entry derives its name from the fact that only a debit or a credit is made for transactions which affect Accounts Receivable or Accounts Payable. It is also called *incomplete double entry*, since it follows, as far as debtors and creditors are concerned, the same principles used in double entry, but merely records one element.

At best, single entry is crude and incomplete and is

seldom used where the bookkeeping work is in competent hands and the management regards its records as important, and where an analysis is desired of the operations of the business. It is found more frequently in the smaller businesses, in records of professional firms or individuals, clubs, societies, and certain similar organizations. In such cases usually the system consists of a record of cash receipts and expenditures, the Cash Book being the principal book or record. Frequently no Ledger is kept, except a record of Accounts Receivable, and Accounts Payable.

As the Ledger does not contain all the Real accounts and practically none of the Nominal accounts, complete financial statements cannot be readily prepared from the book accounts. Usually there is presented a statement of cash receipts and expenditures, classified into the principal classes of income and expense, and a statement of assets and liabilities made up partly from the book accounts and partly from other sources.

The operations of a single entry system may be illustrated by a simple exercise, which is intended to show the principles and methods only. No attempt will be made to present the many variations in the types of records and systems met with in practice. These systems differ according to the individuals who operate them.

The single entry General Journal and Cash Receipts and Payments Journals are illustrated, with a single entry General Ledger.

Illustration of Single Entry. The following transactions are recorded in the records which follow, according to the single entry method.

May, 19—

1. C. B. Adams begins business and invests cash, \$3,000, merchandise valued at \$1,500, and furniture and fixtures, \$500.
3. Bought merchandise for cash, \$450.
4. Bought merchandise from Thompson & Co. on account, \$650.
5. Paid rent, \$100.
6. Sold merchandise to James Brown, \$1,200, on account, 30 days.
7. Borrowed at the bank \$1,000 on a note at 30 days, discount \$5.
8. Bought a store building and lot for \$7,500. Gave a first mortgage for \$4,500; paid balance in cash.
9. Sales for cash, \$550.
10. James Brown paid cash on account, \$600.
11. Bought merchandise of Lewis Smith on account, \$2,000.
15. Returned to Lewis Smith merchandise valued at \$150.
16. Sold to Jackson & Curtis merchandise, \$1,800, on account.
17. Cash sales, \$800.
18. Paid Thompson & Co., less 1 per cent, invoice of 4th.
21. Received from James Brown note to balance account.
23. Received \$14 from bank as interest on checking account.
25. Paid salaries and wages, \$250.
26. Paid freight-in on merchandise, \$22.50.
29. Paid general expenses, \$142.
31. C. B. Adams drew \$500.
31. Assume: merchandise inventory, \$1,100; depreciation, 1 per cent.

Required:

- (a) Record the transactions in Cash Book and Journal.
- (b) Post.
- (c) Make proof of posting.
- (d) Prepare balance sheet.
- (e) Determine profit and loss.

CASH BOOK

RECEIPTS

19—						
May	1	C. B. Adams invested	J			3,000 00
	7	Borrowed on note, 30 da., \$1,000		995 00		
	9	Cash sales		550 00		
	10	James Brown, on account	✓	600 00		
	17	Cash sales		800 00		
	23	Interest on bank account		14 00		
	31	Total receipts			2,959 00	
					5,959 00	

CASH BOOK

PAYMENTS

19—						
May	3	Bought merchandise for cash		450 00		
	5	Paid rent		100 00		
	8	Paid on account of store building Cost \$9,000		3,000 00		
	18	Thompson & Co. Paid Invoice 4th, less 1% — Invoice \$650 — 1% \$6.50	✓	643 50		
	25	Salaries and wages		250 00		
	26	Paid freight on merchandise pur- chased		22 50		
	29	Paid general expenses		142 00		
	31	C. B. Adams withdrew	✓	500 00		
		Total payments			5,108 00	
		Balance			851 00	
					5,959 00	

GENERAL JOURNAL

MAY 1, 19—

C. B. Adams began business this day at 246 Aldworth Street as a retail merchant selling hardware. Invested cash, \$3,000; merchandise valued at \$1,500; and furniture and fixtures at \$500.					
C. B. Adams, Capital	Cr.			5,000	00
Assets invested in the business					
Cash	\$3,000				
Merchandise	1,500				
Furniture	500	\$5,000			
-4-					
Thompson & Co.	Cr.			650	00
Bought merchandise on account as per invoice.					
-6-					
James Brown	Dr.	1,200	00		
Sold merchandise to James Brown on account, 30 days, as per duplicate bill on file.					
-8-					
Bought a store building at 246 Aldworth Street					
Paid \$7,500, giving cash, \$3,000, and a mortgage for \$4,500.					
-11-					
Lewis Smith	Cr.			2,000	00
Bought merchandise on account, as per invoice.					
-15-					
Lewis Smith	Dr.	150	00		
Goods returned.					
-16-					
Jackson & Curtis	Dr.	1,800	00		
Sold merchandise on account, 30 days, as per duplicate bill on file.					
-21-					
James Brown	Cr.			600	00
Received note on account.					
(Note: Sometimes in single-entry no entry is made of the note received until it is paid, then the customer is credited.)					
-18-					
Thompson & Co.	Dr.	6	50		
1% cash discount on invoice.					

LEDGER

C. B. ADAMS, CAPITAL

19— May	31	C	500 00	19— May	1	C	5,000 00
------------	----	---	--------	------------	---	---	----------

THOMPSON & Co.

19— May	18	C	643 50	19— May	4	J	650 00
		J	6 50				

LEWIS SMITH

19— May	15	J	150 00	19— May	11	J	2,000 00
------------	----	---	--------	------------	----	---	----------

JAMES BROWN

19— May	6	J	1,200 00	19— May	10	C	600 00
				May	21	J	600 00

JACKSON & CURTIS

19— May	16	J	1,800 00				
------------	----	---	----------	--	--	--	--

C. B. ADAMS

LEDGER BALANCES, MAY 31, 19—

	<i>Debit</i>	<i>Credit</i>
C. B. Adams, Capital		4,500.00
Lewis Smith		1,850.00
Jackson & Curtis	1,800.00	
	<u>1,800.00</u>	<u>6,350.00</u>

Proof of Posting — Debits

In Ledger Accounts			
C. B. Adams	500.00		
Thompson & Co.	643.50		
Thompson & Co.	6.50		
Lewis Smith	150.00		
James Brown	1,200.00		
Jackson & Curtis	<u>1,800.00</u>		<u>4,300.00</u>
From Cash Payments Book			
Thompson & Co.	643.50		
C. B. Adams	<u>500.00</u>		
	1,143.50		
From Journal			
James Brown	1,200.00		
Lewis Smith	150.00		
Jackson & Curtis	1,800.00		
Thompson & Co.	<u>6.50</u>	<u>3,156.50</u>	<u>4,300.00</u>

Proof of Posting — Credits

In Ledger Accounts			
C. B. Adams	5,000.00		
Thompson & Co.	650.00		
Lewis Smith	2,000.00		
James Brown	<u>1,200.00</u>		<u>8,850.00</u>
From Cash Receipts Book			
James Brown	600.00	600.00	
From Journal			
C. B. Adams	5,000.00		
Thompson & Co.	650.00		
Lewis Smith	2,000.00		
James Brown	<u>600.00</u>	<u>8,250.00</u>	<u>8,850.00</u>

C. B. ADAMS

STATEMENT OF ASSETS AND LIABILITIES, MAY 31, 19—

ASSETS		
Cash on Hand	\$851.00	
Notes Receivable	600.00	
Accounts Receivable		
Jackson & Curtis	1,800.00	
Merchandise Inventory on Hand	<u>2,400.00</u>	\$5,651.00
Furniture and Fixtures	490.00	
Real Estate — Store Building	<u>9,000.00</u>	9,490.00
Total Assets		<u>\$15,141.00</u>

LIABILITIES		
Accounts Payable		
Lewis Smith	\$1,850.00	
Notes Payable	1,000.00	
Mortgage Payable	<u>6,000.00</u>	<u>8,850.00</u>

CAPITAL	
<u>C. B. Adams, Capital</u>	<u>\$6,291.00</u>

ANALYSIS OF NET WORTH	
C. B. Adams, Capital, May 31	\$6,291.00
Less:	
C. B. Adams, Capital, May 1	<u>5,000.00</u>
Net Increase per Statement	1,291.00
Add:	
C. B. Adams, Drawings	<u>500.00</u>
<u>Net Profit</u>	<u>\$1,791.00</u>

Cash Receipts and Payments Journals. The single entry Cash Journals are usually kept in one book, the left-hand page being used for cash received, and the opposite or right-hand page for cash payments. The simplest form is used in this exercise, though there would probably be a special column development worked out, as a matter of expediency, by any one handling cash records in a business with very many transactions.

All entries are recorded in the usual manner in the Cash Journals. The name of the account debited or credited is not shown in any entry except those which affect personal accounts.

General Journal in Single Entry. Entries which affect personal accounts are journalized in the General Journal as to debits or credits to these accounts only, and recorded as in the form illustrated on page 456.

The debit and credit columns may be used, as in the model, or only one column used. Each entry contains the abbreviated form, *Dr.* or *Cr.*, indicating whether the account is to be debited or credited.

This Journal illustrates how the term *single entry* originated. As only one phase of the transaction is recorded, it is natural, in comparing the entries made under each system, to call the one with only one debit or credit recorded, *single entry* and the one with both a debit and a credit recorded, *double entry*.

In a strictly single entry system all postings may be journalized through this General Journal, leaving no postings to be made from other Journals, such as the Cash Journal, as illustrated on page 455.

Posting — Proof of Posting. The debits or credits to the personal accounts are posted according to the entries recorded in the Journals. As the debits and credits are not equal in the Journals, it is obvious that they will not be equal in the Ledger, and that a trial balance cannot be obtained from the accounts. A list of accounts taken from the Ledger would contain the balances of the Customers', Creditors', and Proprietors' accounts, and there is no relation between these debit balances and credit balances.

To prove the correctness of the posting the following method would be used:

1. Add all the debit entries in the Journals and compare with the total of all the debit entries in the Ledger accounts.
2. Add all the credit entries in the Journals and compare with the total of all the credit postings in the Ledger.

These tests operate as a check on the postings made and prove independently the debits and the credits to the accounts which are kept in the Ledger. They merely serve to verify the fact that the debits from the Journals are posted to the debit side of the Ledger and that the credits in the Journals are posted to the credit side of the Ledger. It does not prove, however, that the debits or credits are posted to the proper accounts, or that the debits or credits were correct as entered in the Journals.

Preparation of Statements from Single Entry Books — Balance Sheet. There is no permanent record of the Real accounts or Nominal accounts, and no trial balance containing a complete list of accounts in single entry. To prepare a statement, therefore, such as a Balance Sheet, it is necessary to do so by the appraisal and inventory method.

A list of all assets known to be owned by the business is made and an inventory taken and an appraisal made of the value of each asset. Likewise a list of liabilities is made and the values determined from whatever source is available. The Accounts Receivable and Accounts Payable are, of course, taken from the single entry Ledger, but all other information comes from other sources. Usually there are various vouchers and records available which assist in this procedure. The resulting statement is usually called "A Statement of Assets and Liabilities," or "A Statement of

Resources and Liabilities," at a certain date. The term "Balance Sheet" is customarily used for such a statement when prepared from a set of double entry books.

As this statement is prepared largely from sources external to the books, there is no automatic proof of its accuracy, and it is possible that certain assets and liabilities may be omitted, without the statement revealing the fact. (See form of statement, page 459.)

Profit and Loss Statement from Single Entry Books. In order to prepare a Profit and Loss Statement from a single entry set of records, it would be necessary for the accountant to obtain information by the following methods.

1. Analyze cash receipts and cash expenditures.
2. Note changes in the beginning and the ending statements of assets and liabilities.

By using these methods it is possible to make up a Profit and Loss Statement in approximately double entry form. The following information needed in the Profit and Loss Statement is prepared from the above methods:

From the analysis of cash receipts may be found:

1. Cash sales.
2. Receipts from customers on account.
3. Other income items.

From the analysis of cash payments may be found:

1. Payments to creditors on account.
2. Cash purchases of merchandise.
3. The various operating expenses paid.
4. The non-operating expenses paid.

From the beginning and ending balance sheets may be found:

1. Beginning inventories.
2. Ending inventories.
3. Balances of Accounts Receivable at beginning and end of the period.
4. Balances of Accounts Payable at beginning and end of the period.
5. Balances of other assets and liabilities at beginning and end of the period.

From this information the purchases and sales may be found according to the following formulæ:

Sales:

Credit Sales

Accounts Receivable balance at end	xx	
------------------------------------	----	--

Add:

Cash Received on account	<u>xx</u>	xx
--------------------------	-----------	----

Deduct:

Accounts Receivable at beginning	<u>xx</u>	xxx
----------------------------------	-----------	-----

Cash Sales

xxx

Total Sales for the period

xxx

xxx

Purchases:

Purchases on Credit

Accounts Payable balance at end	xx	
---------------------------------	----	--

Add:

Cash Paid to creditors	<u>xx</u>	xx
------------------------	-----------	----

Deduct:

Accounts Payable at beginning	<u>xx</u>	xxx
-------------------------------	-----------	-----

Add: Cash Purchases

xxx

Total Purchases for the period

xxx

xxx

464 SINGLE ENTRY BOOKKEEPING PROCEDURE

With the information and analysis explained in the preceding paragraphs, a Profit and Loss Statement may be prepared as follows:

Sales (per formula)			xxx
Less:			
Cost of Sales			
Inventory, January 1 (per statement)	xx		
Add:			
Purchases (per formula)	xx		
Total Cost of Merchandise	xx		
Less:			
Inventory, December 31 (per statement)	xx	xxx	
Gross Profit			xxx
Deduct:			
Operating Expenses (per analysis of cash)	xx		
Depreciation (comparison of statements)	xx		
Add:			
Accrued Expenses, December 31 (per statement)		xx	
Expense Inventories, January 1 (per statement)		xx	
Total		xx	
Less:			
Accrued Expenses, January 1 (per statement)	xx		
Expense Inventories, December 31 (per statement)	xx	xx	xxx
Net Operating Profit			xxx
Add:			
Other Income (analysis of cash)	xx		
Other Income (comparison of statements)	xx	xxx	
Total Income			xxx
Other Expenses (analysis of cash)	xx		
Other Expenses (comparison of statements)	xx	xxx	
Net Profit			xxx

Records Rewritten in Double Entry Form. The single entry records may be entirely rewritten in double entry form. If the single entry records were thus rewritten in double entry form and posted properly, a Trial Balance could be prepared as usual in double entry. From this trial balance, with the physical inventory information, a Balance Sheet and Profit Loss Statement may easily be prepared. To rewrite a set of books for a year's time, for example, is an expensive piece of work, and would be done only if necessary. The method explained on pages 462-464 would in most cases be sufficient.

Single Entry — Net Profit or Loss Analysis. Since there is no complete set of accounts in the single entry Ledger and usually no Nominal accounts kept at all, a Profit and Loss Statement, such as is made from a double entry set of records, is possible only through an analysis as explained in preceding paragraphs.

The net profit or loss from single entry books is, therefore, usually determined by a comparison and analysis of the capital at the beginning and end of the period. The net result of capital changes is thus determined, but there is no detailed analysis of income and expenses for the period.

In making this comparison of net worths, consideration must be given to changes in capital during the period. Obviously, if the capital at the beginning of a period was \$10,000, and at the end \$15,000, there is an increase of \$5,000 in the capital. This \$5,000 may represent a net profit, provided there has been no change in the capital during the period due to drawings or additional investments by the proprietor. It would be evident, in the case above stated, that if the proprietor had invested \$5,000 additional during the period, the increase of \$5,000 was entirely due to

his contribution and not a profit from operations. Also, if he withdrew \$5,000 during the period, the increase in capital of \$5,000, as shown, represents net profits remaining in the business, but as \$5,000 has been withdrawn, there must have been a net operating profit of \$10,000 made during the period.

The formula for determining net profit by comparison of net worths may be expressed in either of two ways, namely:

1. Net difference of capital from comparative statements
 (Capital₂ — Capital₁, algebraically plus or minus as the case may be)
 Plus: Withdrawals by proprietor
 Less: Additional investments
 Equals: True net profit or loss
2. Capital at the end plus withdrawals less additional investments
 Less: Capital at the beginning
 Equals: True net profit, if positive; if negative, the result is a net loss

Changing from Single Entry to Double Entry. The process of changing from single entry to double entry is as follows:

1. Prepare a chart of accounts and open all of the accounts in the General Ledger.
2. Prepare the Journals, such as are to be used in double entry, and start recording all transactions according to double entry methods on a certain date, preferably the beginning of a period.
3. Prepare a statement of assets and liabilities as of the end of the period previous to starting the books in double entry form.
4. Make an opening entry in the Journal, debiting the Assets and crediting the Liabilities and Capital at the values shown in the statement prepared as stated in number 3 above.

The entry or entries made as described under number 4 are then posted into the Ledger accounts. The Ledger is now in balance, and it is only necessary to keep the Journals by double entry and post accordingly in the future.

An entirely new Ledger may be used in which the entry made to change to double entry would be posted. If the old Ledger is to be used, only such accounts need be opened as are not already open in this Ledger. As the old Ledger contains personal accounts only, all other Real and Nominal accounts must be opened.

The Proprietor's account on the old Ledger should be adjusted to agree with the balance shown in the opening entry. This should be done by recording the profit or loss for the previous period in this account. Other details in the opening of the new system would depend on the plan of the new double entry records.

Disadvantages of Single Entry. It is evident that single entry is not a complete system and, therefore, there are many disadvantages.

1. There is usually a lack of any definite system or carefully planned method of keeping the books and no complete information is readily available.
2. As a trial balance cannot be taken, there is no convenient way of proving the mathematical accuracy of the bookkeeper's work.
3. As there are no Nominal accounts kept, the benefit of a detail analysis of operations is lacking. An analysis of the Profit and Loss Statement is important for operating efficiency; therefore, there is greater risk of losses occurring frequently.
4. There is no permanent record of the Real accounts of the business; hence the Balance Sheet must be prepared by the inventory and appraisal method each period, and errors and omissions are likely to occur.
5. Comparisons between the operations of different fiscal periods are not possible.

Advantage of Single Entry. The only advantage which may be claimed for single entry is that it is simple and inexpensive to operate, and does not require a highly trained bookkeeper.

The methods of analysis used in single entry are very helpful in many problems in modern accounting. Particularly is this true in present-day income tax problems and in analysis of incomplete and poorly kept double entry systems.

MATERIAL FOR CLASS DEMONSTRATION AND DISCUSSION

1. Explain single entry bookkeeping.
2. Where is single entry more commonly found?
3. Explain the method of recording an entry in journals under the single entry plan.
4. Explain how postings are proved.
5. How are statements prepared from single entry records?
6. Distinguish between a Balance Sheet and a Statement of Assets and Liabilities.
7. How is it possible to prepare a Statement of Profit and Loss from single entry records?
8. Give the formula for determining sales.
9. Give the formula for determining purchases.
10. Explain the method of determining net profit and loss by analysis of capital.
11. How do you change from single entry to double entry?
12. Are there any advantages to single entry?
13. Name some of its disadvantages.
14. Describe the analysis which it is necessary to make in order to prepare complete statements in detail from single entry records.

INDEX

INDEX

- Acceptance, of time drafts, 150; trade, 153-56; discounting trade, 194; trade. *See also* Negotiable Instruments
- Account, definitions of, 32; ledger form, 36, 37; debit and credit sides of, 37, 38; balance of, 69, 70; balancing, 78, 79; open, 79; closed, 79; profit and loss, 87; revenue, 87; agreement in ledger and balance sheet of capital, 91, 92; opening of profit and loss, 92; opening of checking, 174, 175
- Accountants, development of professional societies of, 4, 5
- Accounting, definition, 1; history, 1, 2; legal recognition in United States, 2, 3; relation of bookkeeping to, 5; relation to economics, 6; relation to law, 6; relation to management, 6, 7; separation of private and business interests in, 17-19
- Accounts, classification of, 33, 34; asset, 33; liability, 33; capital, 33; real, 33; nominal, 33, 34; income, 33, 34; expense, 33, 34; chart of, 34-36; changes in classification of, 41, 42; order of opening, 53; ruling balanced, 77, 78; temporary proprietorship, 99; nominal, as temporary proprietorship accounts, 99; mixed, 118, 119, 133, 249; classification of, 235; adjustment of mixed, 251-60; arrangement in balance sheet, 315; methods of treating adjustment, 327-35
- Accounts, Controlling, operation of, 201-04; setting up, 200, 201; effect on general ledger trial balance, 204, 205; posting to, 205-08; effect on bookkeeping plan, 221, 222; schedules of, 221, 222; posting problems of, 222
- Accounts payable, definition, 14
- Accounts receivable, as assets, 12; advantages of notes receivable over, 148
- Accruals, adjusting entries to record, 257-60
- Adjustment, entries for, 248-51; of mixed accounts, 251-60; for inventory, 252, 253; for stationery and supplies, 254; for prepaid insurance, 254, 255; for interest paid in advance, 255-57; for accruals, 257-60; for accrued interest, 257, 258; for taxes, 258-60; for depreciation, 262-73; of trial balance accounts on working sheet, 281-89; on analysis sheets, 295-304; treatment of real accounts resulting from, 327-35; treatment of accounts, allowed to remain open, resulting from, 333-35
- Allowances, purchase and sales, 227-29
- American Association of Public Accountants, 4
- American Institute of Accountants, 4
- American Society of Certified Public Accountants, 4
- Analysis sheets, preparation of, 292-305; method compared with working sheet, 305, 306; recording of adjusting entries in Journal, 306
- Assets, different types of, 12; tangible and intangible, 12; net, 12, 13; depreciation of fixed, 262; book value of, 265; subdivision in balance sheet, 308; current, 308, 309; fixed, 309, 310; deferred, 310; net current, 314; interest of partners' in, 370, 371
- Bad debts, provision for loss on, 273; actual loss method of accounting for, 273, 274, 278; estimated loss method of accounting for, 274-78; reserve for, 274-78; adjustment for on working sheet, 282, 283; adjustment on analysis sheets, 295-98
- Balance, of account, 69, 70; debit or credit, 70; trial. *See* Trial balance
- Balance sheet, illustration and definition, 15, 16; based upon equations, 16; effect of business transactions on equation of, 22-31; preparation of, 84-86; other titles of, 86; relationship to profit and loss statement, 88, 89; relationship to trial balance, 88, 89; importance of, 234; effect of business transactions on equation of, 234; function of, 238; chart of equation, 240, 241; reserves for depreciation in, 266; classification of assets in, 308-10; classification of liabilities in, 310, 311; classification of capital in, 311, 312; illustrative, 312, 313, 316, 317; report form, 314; capital section of, 314, 315; account form, 314, 316, 317; arrangement of accounts in, 315; method of showing contingent lia-

- bilities on, 318; analysis of, 318, 319; in departmentalized business, 350; form of partnership, 392, 393; corporate, 447; from single entry books, 459, 461, 462
- Balancing, an account, 78, 79
- Banks, functions of commercial, 174; uniform system of numbers of, 178-80
- Bills, receivable or payable, 149
- Bonds, as assets, 12
- Book, meaning of term in accounting, 49; bank pass, 180; use of check, 180-82; reconciliation of monthly statement and balance in check, 184-86
- Bookkeeping, teaching in schools and colleges, 3, 4; relation to accounting, 5; double entry, 49, 236; steps in, 236; labor-saving devices, 241-43; double entry versus single entry, 452, 453; changing from single entry to double entry, 466, 467
- Bookkeeping, single entry, 452-68; double entry versus, 452, 453; illustration of, 453-59; rewritten in double entry form, 465; changing to double entry, 466, 467; disadvantages of, 467; advantage of, 468
- Books, of original entry and final entry, 54; closing the, 91-100, 238, 239. *See also* Records
- Business, owner's investment in, 17; accounting for service, 34-47, 244; definition of trading, 101; accounting for trading, 101-17, 244; accounts of trading and of commission, 105, 106; model illustrative exercise in accounting for trading, 118-40
- Capital, as owner's interest in property, 12, 13; as proprietor's investment, 17; determination of net profit and loss from analysis of, 27, 28; subdivision in balance sheet, 311, 312; working, 314; methods of showing in balance sheet, 314, 315; "borrowed," 319; "owned," 319; meaning of term, 438; distinguished from capital stock, 439, 440; accounts relating to surplus, 444, 445; summary of ownership, 449
- Capital stock, of corporation, 438, 439; distinguished from capital, 439, 440; par value, 440; no-par value, 440, 441; classification of, 442, 443; accounts relating to, 445
- Cash, accounting for, 224, 225; petty, 225-27; purchases and sales for, 343-46; petty, in departmentalized business, 346, 347
- Cash Book, use of, 164-68; columnar development of, 208-15; posting of, 209-11; departmentalization of, 346; single entry, 453, 455, 459, 460
- Charges, deferred, 310
- Checks, use of, 144-46, 174-86
- C.I.F., definition, 115
- Closing, the books, 91-100
- C.O.D., definition, 115
- Cole, W. M., definition of account, 32; *Fundamentals of Accounting*, 32
- Colleges, development of commercial subjects in, 3, 4
- Columns, special, in Cash Book, 208-15
- Commercial subjects, development in schools and colleges, 3, 4
- Company, joint stock, 367
- Copartnership, articles of, 364
- Corporation, quasi-, 367; as type of business organization, 436, 450; procedure for formation of, 436, 437; management of, 437, 438; capital stock of, 438-41; control of earnings of, 441; dividends of, 441; classification of capital stock of, 442, 443; accounts relating to capital and dividends of, 443-45; records of, 445, 446; characteristics of, 446; balance sheet of, 447; analysis of surplus of, 448; net worth of, 448
- Credit, property acquired on, 13, 14. *See also* Debit and credit
- Creditor, definition, 13; precedence of interest of, 14
- Creditors, equation involving interest in property, 14, 15; relation of interest to proprietor's interest, 16
- Days of grace, for payment of sight draft, 153
- Debit and credit, uses of terms, 37, 38; theory of, 38-40, 235, 236; rules for, 40-42; application of rules for, 42-47; equality of, 48; application of theory in double entry bookkeeping, 49-67
- Debtor, definition, 13
- Debts, bad. *See* Bad debts
- Departmentalization, necessity for, 337; subdivision of trading accounts for, 337-40; changes in books of original entry for, 341-47; profit and loss statement under, 349, 350; balance sheet under, 350; of operating expenses, 357-61
- Deposit, slips, 175-80

- Depreciation, adjustments for, 262-73; of fixed assets, 262; calculation of charge for, 263, 264; based on estimate, 264; account, 264; reserves for, 264-73; entries for, 266-68; adjustment for on working sheet, 284, 285; adjustment for on analysis sheets, 299, 300
- Discount, interest and, 187-99; of non-interest-bearing negotiable instruments, 191, 192; accounting for, 192-98
- Discounts, based on purchases and sales, 113-16; trade, 113, 114; cash, 114-16
- Dividends, of corporation, 441; account relating to, 445
- Drafts, definition, 149; time, 149-52; significance of date of acceptance of time, 150; parties to, 150, 151; three-party, 151; two-party, 151-53; bank, 152; sight, 153; discounting two-party, 193. *See also* Negotiable instruments
- Drawing account, proprietor's, 311, 312
- Economics, relation to accounting, 6
- England, founding of professional societies in, 4
- Entry, journal, 50, 51; books of original and final, 54
- Entries, adjusting, 248-51; reversing, 327-35
- E.O.M., definition, 115
- Equation, of creditors' and proprietor's interest in property, 14, 15; balance sheet, 16, 234; chart of balance sheet, 240, 241
- Errors, location of in trial balance, 71-73; correction in Journal and Ledger, 73-76
- Exhibits, business statements called, 350
- Expense, definition of, 25
- Expenses, operating, 322; non-operating, 322; subdivision in profit and loss statement, 322; classification and distribution of, 352; functional classification of operating, 352-57; administrative, 352, 353; buying, 352, 353; selling, 352-54; distribution to departments of operating, 357-61
- Express inward, distribution to departments, 340
- F.O.B., definition, 115
- Freight, express and cartage in account in trading business, 102; distribution to departments, 340
- Goodwill, nature of, 399, 400; in admission of partner, 400-03; valuation of, 405, 406; belonging to new partner, 414, 415
- History, of accounting, 1, 2
- Income, definition of, 25; definition of net, 28; subdivisions in profit and loss statement, 321; operating, 321; non-operating, other, financial, or extraneous, 321, 322
- Income sheet, 87
- Incorporation, procedure for, 436, 437
- Indorsement, of negotiable instruments, 141, 142; blank, 142; full, 142, 143; restrictive, 143; qualified, 143, 144; significance of, 144
- Indorser, contingent liability of, 198, 199
- Insolvency, definition and illustration, 16, 17; net, 16, 17
- Institute of Accountants, Scotland, 4
- Institute of Chartered Accountants, England, 4
- Instruments, negotiable. *See* Negotiable instruments
- Insurance, adjustment for prepaid, 254, 255; adjustment on working sheet for prepaid, 286, 287; adjustment on analysis sheets for prepaid, 301
- Interest, proprietary, 12, 13; and discount, 187-99; calculation of, 187; ordinary, or bankers' method, 187, 188; exact, 188, 189; accounting for, 189-91; on partners' investments, 380-82
- Interest, accrued, adjustment for, 257, 258; adjustment on working sheet, 281, 282, 285, 286; adjustment on analysis sheets, 295, 300
- Interest, prepaid, adjustment for, 255-57; adjustment on working sheet, 287, 288; adjustment on analysis sheets, 301-04
- Inventory, merchandise account, in trading business, 103; accounting for merchandise, 133, 138, 251, 252; problem of valuation in, 252; adjustment for, 252, 253; at beginning of period, 253; adjustment for on working sheet, 283, 284; adjustment for on analysis sheets, 298, 299
- Investment, by proprietor in business, 17; separate accounting for, 17-19
- Invoice, purchase, 108; form of, 110; purposes of, 110; terms of, 114, 115
- I.O.U.'s, accounting for, 227

- Journal, entries in, 50, 51; as book of original entry, 54; as sole book of original entry, 158, 159; subdivision of, 159-72; use of General, 168-71; advantages of subdivision of, 171, 172; development of General, 216-19; Purchase Returns, 228; Sales Returns, 228, 229; Note, 229-31; single entry General, 456, 460; single entry Cash, 459, 460
- Journalizing, definition, 51; importance of, 236, 237
- Labor-saving devices, bookkeeping, 241-43
- Law, recognition of accounting in United States by, 2, 3; relation to accounting, 6
- Ledger, account form, 36, 37; use of, 51; posting to, 51, 52; book of final entry, 54; closing, 92-95, 238, 239; subdivision of, 200; single entry, 457, 458
- Ledgers, subsidiary, 201; loose-leaf, 204
- Liabilities, definition, 14; precedence of, 14; contingent, 198, 199; subdivision in balance sheet, 310; current, 311; fixed, 311; showing in balance sheet of contingent, 318
- Loan account, partner's, 382, 383
- Loss, definition of net, 28; distribution to partners of net, 388-91. *See also* Profit and loss
- Management, relation to accounting, 6, 7
- Memorandum, debit, 113; credit, 113
- Merchandise, definition, 101; accounts in trading business, 102-04; inventory account in trading business, 103
- Method, reversing, 328, 330-33; split, 328-30
- Mortgage payable, as fixed liability, 311
- National Association of Cost Accountants, 4, 5
- Negotiable instruments, definition, 141; indorsement of, 141-44; uses of ordinary, 144-55; manner of making out, 145, 146; interest-bearing, 187; discounting of non-interest-bearing, 191, 192; discounting of interest-bearing, 196-98; bank practices as to due dates, 198
- Net worth, of corporation, 448; analysis of from single entry books, 459, 465
- Notes, promissory, 146-49. *See also* Negotiable instruments
- Notes payable, definition, 14; accounting for, 148, 149; accounting for interest-bearing, 190, 191; accounting for discounted, 194, 195
- Notes receivable, as assets, 12; accounting for, 147-49; advantages over accounts receivable, 148; accounting for interest-bearing, 189, 190; discounting non-interest-bearing, 192, 193; accounting for discounted interest-bearing, 196-98
- Organization, types of business, 434-51
- Orders, form of, 107; sales, 107; purchase, 108, 109
- Owner. *See* Proprietor
- Pacioli, L., beginning of modern accounting by, 1, 2; *Summa de Arithmetica, Geometria, Proportioni, et Proportionalita*, 1, 2
- Partner, general, 367; special, 367; ostensible, 367; secret, 368; silent, 368; dormant, 368; investment account of, 373, 374; drawings by, 374, 375; drawing account of, 375, 378; salary account of, 377, 378; loan account of, 382, 383; admission of, 397-421; problems in admission of new, 397, 398; interest in business of, 398, 399; accounting for goodwill in admission of, 400-03; investment of new capital by new, 415-19; goodwill belonging to new, 414, 415
- Partners, individual control by, 364; co-ownership of profits and losses, 365; co-ownership of assets, 365; liability for debts of firm, 365; classification of, 367, 368; capital interest versus profit and loss interest of, 369-70; interest in assets, 370, 371; interest in profits and losses, 371; need for records of interest of, 373; salaries of, 375-77; classification of salaries of, 378-80; interest allowances on investments of, 380-82; adjusting accounts of, on admission of new partner, 401-05. *See also* Partnership
- Partnership, nature of, 363; contract, 364; characteristics of, 364, 365; limited life of, 364, 365; legal interpretations affecting entity, 365; types of, 366, 367; general, 366; special, 366; trading, 366; non-trading, 366; ordinary or regular, 366; limited, 366, 367; advantages and disadvantages of, 368, 369; accounting problems created by, 369-71; accounts, 373-96; sharing results of operation of, 385-91; form of balance sheet, 392, 393; form of operating statement, 394;

- form of distribution of net profit in, 395; terminology of, 398, 399; buying an interest in, 408-15; investment of new capital by new partner in, 415-19; dissolution of, 422-33; provision for dissolution of, 432; notice of dissolution of, 432; as type of business organization, 435, 436, 450. *See also* Partners
- Pass book, bank, 180
- Percentage, use in analysis of profit and loss statement, 324-27
- Periods, accounting, 81, 82
- Posting, to ledger, 51, 52; process of, 52, 53, 237; to controlling account, 205-08; of Cash Book, 209-11; of general and subsidiary ledgers, 222; in single entry, 458, 460, 461
- Profit, definition of net, 28; net, in balance sheet and profit and loss statement, 88; accounting for gross, 101, 102; method of obtaining gross, 104; net, on working sheet, 290; partners' salaries and interest allowances as elements of economic net, 379-82; sharing of partnership, 385-88, 395
- Profit and loss, determination from capital of net, 27, 28; net, derived from difference between income and expense, 28, 29; deferred charges to, 310; interest of partners in, 371
- Profit and loss statement, explanation of, 87, 88; relationship to balance sheet, 88, 89; relationship to trial balance, 88, 89; function of, 238; purpose of, 321; classification of income in, 321, 322; classification of expense in, 322; form of, 322, 323; illustrative, 324; use of percentage in analysis of, 324-27; of departmentalized business, 349, 350; illustrative departmentalized, 358-60; from single entry books, 462-64
- Property, definition, 11; ownership of, 11, 12; as assets, 12; capital as owner's interest in, 12, 13; acquired on credit, 13, 14; equation of creditors' and proprietor's interest in, 14, 15; relation of proprietor's and creditors' interests in, 16; separation of business and private, 17-19
- Proprietor, equation involving interest in property, 14, 15; relation of interest to creditors' interest, 16; capital as investment of, 17; separation of business and private interests of, 17-19; capital account and drawing account of, 311, 312
- Proprietorship, definition, 12, 13; single, as type of business organization, 434, 435, 450
- Purchases, account, in trading business, 102; returns and allowances account, in trading business, 102, 103; discounts on, 114-16; cash, 343, 344
- Purchases Book, use of, 159-62; posting, 208
- Ratio, "working capital," 318
- Receipts, form of, 106, 107
- Receivables, definition of intangible, 12
- Records, interpretation of, 81-90; supplementary, for trading business, 106-13. *See also* Books
- Register, Notes Receivable, 229-31; Notes Payable, 230, 231; departmentalization of Invoice, 342-44
- Reserve, meaning of, 265; for bad debts, 275-78
- Reserves, for depreciation, 264-73
- Returns, purchase and sales, 227-29
- Rights, acquisition of property, 11, 12
- Ruling, of accounts which balance, 77, 78
- Sales, on account, 12; account in trading business, 103, 104; returns and allowances account in trading business, 104; discounts on, 114-16
- Sales Book, use of, 162-64; posting, 207; departmentalization of, 344-46
- Schedules, of controlling accounts, 221, 222; details of exhibits shown in, 350
- Schools, development of commercial subjects in, 3
- Scotland, founding of professional societies in, 4
- Sheets. *See* Balance Sheet, Working Sheets and Analysis Sheets
- Signature, of check, 174, 175
- Slips, bank deposit, 175-80; duplicate deposit, 180
- Societies, development of professional, 4, 5
- Society of Incorporated Accountants and Auditors, England, 4
- Sprague, C. E., definition of account, 32; *Philosophy of Accounts*, 32
- Statement, definition of financial, 81; of assets and liabilities, 86; of resources and liabilities, 86; of condition, 86; of income and expense, 87; of revenue and expense, 87; operating, 87; profit and loss, 87; other titles of profit and loss, 87, 88; customer's monthly, 110-12; monthly bank, 182, 183; reconciliation of check book balance and monthly

- bank, 184-86; form of partnership operating, 394; of assets and liabilities from single entry books, 461, 462. *See also* Profit and loss statement
- Statements, basis for preparation of, 81; preparation of financial, 82-89, 237, 238; preparation of from single entry books, 461-66
- Stationery and supplies, adjustment for, 254; adjustment on working sheet, 286; adjustment on analysis sheets, 300, 301
- Stock, common, 442; preferred, 442, 443; guaranteed, 443. *See also* Capital stock
- Stocks, as assets, 12
- Surplus, capital, 444; earned, 445; analysis of, 448
- Taxes, adjustment for, 258-60; adjustment on working sheet for accrued, 288; adjustment on analysis sheets for accrued, 304
- Time, accounting periods of, 247, 248
- Transactions, business, and their effect on balance sheet equation, 22-31; definition of business, 22; classification of business, 22-27
- Trial balance, definition, 68; of totals, 68; of balances, 69-71; value of, 71; location of errors in, 71-73; mechanics of taking, 76, 77; in working sheet, 83, 84, 281; relationship to balance sheet and profit and loss statement, 88, 89; proof, final, post-closing, or after closing, 95, 239; effect of controlling accounts on general ledger, 204, 205; function of, 237
- United States, legal recognition of accounting in, 2, 3; founding of professional societies in, 4, 5
- Valuation, inventory, 252
- Value, book, 265
- Vouchers, kinds of, 106-13; petty cash, 225, 226
- Working sheet, six-column, 82-84; form of, 280; procedure in making, 281-90; recording of adjustments in journal, 291; method compared with analysis sheets, 305, 306
- Worth, net, 12, 13; present, 12, 13
- Year, fiscal, 82; calendar, 82; natural business, 247, 248

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